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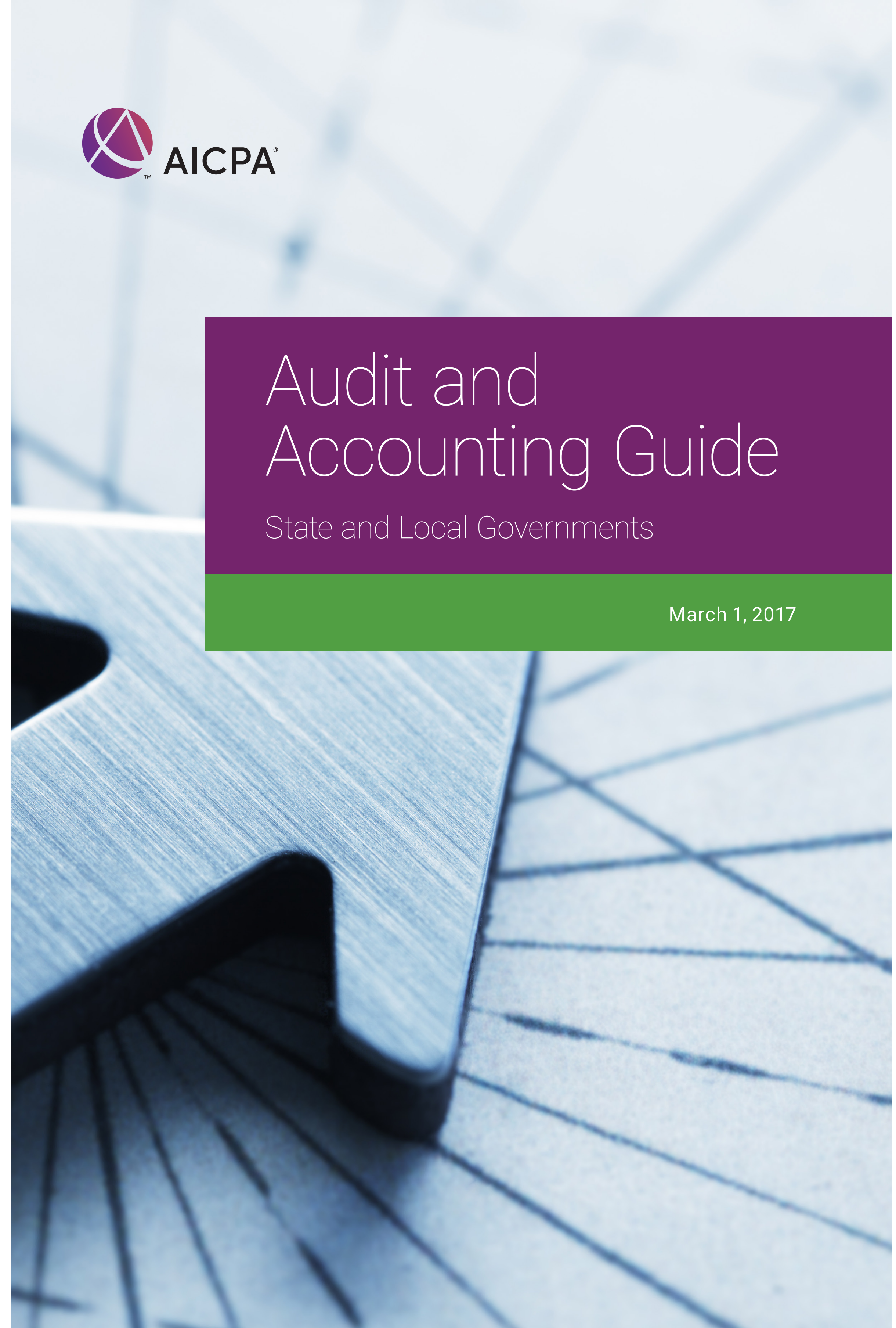

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Audit and Accounting Guide

State and Local Governments

March 1, 2017

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Audit and Accounting Guide

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March 1, 2017

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Preface

(Updated as of March 1, 2017)

Prepared by the State and Local Government Audit Guide Revision Task Force.

About AICPA Guides

This AICPA Guide has been developed by the AICPA State and Local Government Audit Guide Revision Task Force (task force) to assist management in the preparation of their financial statements in conformity with U.S. generally accepted accounting principles (GAAP) and to assist practitioners in performing and reporting on their audit engagements.

AICPA Guides may include certain content presented as "Supplement," "Appendix," or "Exhibit." A supplement is a reproduction, in whole or in part, of authoritative guidance originally issued by a standard setting body (including regulatory bodies) and applicable to entities or engagements within the purview of that standard setter, independent of the authoritative status of the applicable AICPA Guide. Both appendixes and exhibits are included for informational purposes and have no authoritative status.

The Financial Reporting Executive Committee (FinREC) is the designated senior committee of the AICPA authorized to speak for the AICPA in the areas of financial accounting and reporting. Conforming changes made to the financial accounting and reporting guidance contained in this guide are approved by the FinREC Chair (or his or her designee). Updates made to the financial accounting and reporting guidance in this guide exceeding that of conforming changes are approved by the affirmative vote of at least two-thirds of the members of FinREC.

New to the guide in this year's edition is chapter 14, "Defined Benefit Postemployment Benefits Other Than Pensions (Plan & Employer Considerations)."

This chapter describes the financial accounting and requirements set forth by GASB and provides related audit guidance but does not establish any new financial accounting or reporting guidance. Therefore, the addition of the new chapter is considered a conforming change for purposes of FinREC's clearance process.

The AICPA would like to express its gratitude to Jeffrey Markert, member of the AICPA State and Local Government Expert Panel, for his considerable contribution towards the development of chapter 14. We would also like to acknowledge the following members of the AICPA State and Local Government Expert Panel who reviewed or otherwise contributed to the development of chapter 14: Heather Acker, chair; Corey Arvizu; Joel Black; Stephen Blann; Edward Chait; John Good; Reem Samra; Robert Scott; and Michelle Watterworth. The AICPA would also like to thank Marilee Lau, a consultant in benefit plan accounting and auditing issues, for her contribution to the development of chapter 14.

This guide does the following:

- Identifies certain requirements set forth in GAAP for governmental entities.
- Describes FinREC's understanding of prevalent or sole industry practice concerning certain issues. In addition, this guide may indicate that FinREC expresses a preference for the prevalent or sole industry practice, or it may indicate that FinREC expresses a preference for another practice that is not the prevalent or sole industry practice; alternatively, FinREC may express no view on the matter.
- Identifies certain other, but not necessarily all, industry practices concerning certain accounting issues without expressing FinREC's views on them.
- Provides guidance that has been supported by FinREC on the accounting, reporting, or disclosure treatment of transactions or events that are not set forth in GAAP for governmental entities.

Accounting guidance for governmental entities included in an AICPA Guide, and cleared by GASB, is a source of authoritative GAAP described in category B of the hierarchy of GAAP for state and local governmental entities as defined in GASB Statement No. 76, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*. The accounting provisions of this guide that have been cleared by GASB are formatted in orange font for the reader within the text of the guide and are noted in appendix B, "Category B Guidance." AICPA members should be prepared to justify departures from GAAP as discussed in the "Accounting Principles Rule" (AICPA, *Professional Standards*, ET sec. 1.320.001 and 2.320.001).

An AICPA Guide containing auditing guidance related to generally accepted auditing standards (GAAS) is recognized as an interpretive publication as defined in AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*). Interpretive publications are recommendations on the application of GAAS in specific circumstances, including engagements for entities in specialized industries.

Interpretive publications are issued under the authority of the AICPA Auditing Standards Board (ASB) after all ASB members have been provided an opportunity to consider and comment on whether the proposed interpretive publication is consistent with GAAS. The members of the ASB have found the auditing guidance in this guide to be consistent with existing GAAS.

Although interpretive publications are not auditing standards, AU-C section 200 requires the auditor to consider applicable interpretive publications in planning and performing the audit because interpretive publications are relevant to the proper application of GAAS in specific circumstances. If the auditor does not apply the auditing guidance in an applicable interpretive publication, the auditor should document how the requirements of GAAS were complied within the circumstances addressed by such auditing guidance.

The ASB is the designated senior committee of the AICPA authorized to speak for the AICPA on all matters related to auditing. Conforming changes made to the auditing guidance contained in this guide are approved by the ASB Chair (or his or her designee) and the Director of the AICPA Audit and Attest Standards Staff. Updates made to the auditing guidance in this guide exceeding that of conforming changes are issued after all ASB members have been provided an opportunity to consider and comment on whether the guide is consistent with the Statements on Auditing Standards (SASs).

Any auditing guidance in a guide appendix or chapter appendix in a guide, or in an exhibit, although not authoritative, is considered an "other auditing publication." In applying such guidance, the auditor should, exercising professional judgment, assess the relevance and appropriateness of such guidance to the circumstances of the audit. Although the auditor determines the relevance of other auditing guidance, auditing guidance in a guide appendix or exhibit has been reviewed by the AICPA Audit and Attest Standards staff and the auditor may presume that it is appropriate.

An AICPA Guide containing attestation guidance is recognized as an interpretive publication as defined in AT-C section 105, *Concepts Common to All Attestation Engagements* (AICPA, *Professional Standards*). Interpretive publications are recommendations on the application of Statements on Standards for Attestation Engagements (SSAEs or attestation standards) in specific circumstances, including engagements for entities in specialized industries. Interpretive publications are issued under the authority of the ASB. The members of the ASB have found the attestation guidance in this guide to be consistent with existing SSAEs.

A practitioner should be aware of and consider the guidance in this AICPA Guide applicable to his or her attestation engagement. If the practitioner does not apply the attestation guidance included in an applicable AICPA Guide, the practitioner should be prepared to explain how the he or she complied with the SSAE provisions addressed by such attestation guidance.

Any attestation guidance in a guide appendix or chapter appendix in a guide, or in an exhibit, although not authoritative, is considered an "other attestation publication." In applying such guidance, the practitioner should, exercising professional judgment, assess the relevance and appropriateness of such guidance to the circumstances of the engagement. Although the practitioner determines the relevance of other attestation guidance, such guidance in a guide appendix or exhibit has been reviewed by the AICPA Audit and Attest Standards staff and the practitioner may presume that it is appropriate.

The ASB is the designated senior committee of the AICPA authorized to speak for the AICPA on all matters related to attestation. Conforming changes made to the attestation guidance contained in this guide are approved by the ASB Chair (or his or her designee) and the Director of the AICPA Audit and Attest Standards Staff. Updates made to the attestation guidance in this guide exceeding that of conforming changes are issued after all ASB members have been provided an opportunity to consider and comment on whether the guide is consistent with the SSAEs.

Purpose and Applicability

The AICPA developed this guide to help auditors understand the GAAP applicable to the financial statements of state and local governments and audit and report on those financial statements in accordance with GAAS. This guide is designed as a tool for auditors of governmental entities of all sizes. The nature, timing, and extent of auditing procedures in a particular engagement are matters of professional judgment and will vary depending upon numerous factors, including the size of the entity and its organizational structure and internal control, materiality considerations, the auditor's assessment of risk, and applicable laws, regulations, and provisions of grants and contracts.

This guide applies to all state and local governments as defined in chapter 1, "Overview and Introduction." Certain other AICPA Guides also apply to audits of certain state and local governments, as discussed in chapter 1. In particular, auditors who perform audits under *Government Auditing Standards*, the Single Audit Act Amendments of 1996, and Title 2 U.S. *Code of Federal Regulations* Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards*, should refer to the AICPA Audit Guide Government Auditing Standards *and Single Audits*.

Limitations and Coverage

This guide is designed to provide guidance to auditors who are new to state and local governmental accounting and auditing as well as to auditors experienced in state and local governmental accounting and auditing. This guide assumes that the auditor has expertise in accounting and auditing, in general, but not necessarily in the specialized accounting and auditing practices applicable to state and local governments. Therefore, the guide concentrates on the accounting standards and auditing procedures that are unique to or significant for those governments. This guide also is intended to be useful in providing accounting and financial reporting guidance to preparers of governmental financial statements. The guidance presented here is not all inclusive; it is limited to certain matters that warrant special emphasis or that experience has indicated may be useful. Although this guide does not incorporate, repeat, or summarize all authoritative pronouncements that apply to state and local governments, it does consider relevant guidance contained in authoritative pronouncements through those indicated in this preface.

Authoritative pronouncements should be applied based on the effective dates in the pronouncements. The AICPA staff will make conforming changes to this guide annually to incorporate relevant guidance in new accounting and auditing pronouncements. Users of this guide should consider pronouncements issued after those listed in this preface to consider their effect on state and local governments.

Recognition

2017 Guide Edition

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Gerry Boaz, Member

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The AICPA gratefully acknowledges John Good for his valuable assistance in updating the 2017 edition of the guide.

The AICPA gratefully acknowledges those members of the AICPA State and Local Government Expert Panel who reviewed or otherwise contributed to the development of this edition of the guide: Corey Arvizu, Joel Black, Stephen Blann, Edward Chait, Kathy Lai, Tamara Miramontes, Flo Ostrum, Reem Samra, Robert Scott, Michelle Watterworth, Walker Wilkerson, and the chair of the Expert Panel, Heather Acker.

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Guidance Considered in This Edition

This edition of the guide has been modified by the AICPA staff to include certain changes necessary due to the issuance of authoritative guidance since the guide was originally issued, and other revisions as deemed appropriate, including a new chapter 14 addressing postemployment benefits other than pensions (OPEB) from both the plan and participating employer perspective. Relevant guidance issued through March 1, 2017, has been considered in the development of this edition of the guide. However, this guide does not include all audit, accounting, reporting, and other requirements applicable to an entity or a particular engagement. This guide is intended to be used in conjunction with all applicable sources of relevant guidance.

Relevant guidance that is issued and effective on or before March 1, 2017, is incorporated directly in the text of this guide. Additionally, authoritative guidance for the following GASB statements are also incorporated directly into the text of this guide: GASB Statement Nos. 73, *Accounting and Financial Reporting for Pensions and Related Assets That Are Not Within the Scope of GASB Statement 68, and Amendments to Certain Provisions of GASB Statements 67 and 68*; 74, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*; 80, *Blending Requirements for Certain Component Units—an amendment of GASB Statement No. 14*; and 82, *Pension Issues—an amendment of GASB Statements No. 67, No. 68, and No. 73* (all effective for periods beginning after June 15, 2016); and No. 81, *Irrevocable Split-Interest Agreements* (effective for periods beginning after December 15, 2016). GASB Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions* (effective for fiscal years beginning after June 15, 2017) is incorporated into the guide solely in chapter 14 as detailed in the "New OPEB Chapter" section of this preface (the remainder of the guide references GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, as the current guidance).

Relevant guidance issued but not yet effective as of the date of the guide and not becoming effective until after June 30, 2017, is referenced in a "guidance update" box; that is, a box that contains summary information on the guidance issued but not yet effective.

In updating this guide, all guidance issued up to and including the following was considered, but not necessarily incorporated, as determined based on applicability:

- GASB Statement No. 84, *Fiduciary Activities*
- GASB Interpretation No. 6, *Recognition and Measurement of Certain Liabilities and Expenditures in Governmental Fund Financial Statements—an interpretation of NCGA Statements 1, 4, and 5; NCGA Interpretation 8; and GASB Statements No. 10, 16, and 18*
- GASB Technical Bulletin No. 2008-1, *Determining the Annual Required Contribution Adjustment for Postemployment Benefits*
- GASB Concepts Statement No. 6, *Measurement of Elements of Financial Statements*
- GASB *Implementation Guide No. 2016-1, Implementation Guidance Update—2016*
- SAS No. 132, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, AU-C sec. 570)
- Statement of Position 13-2, *Performing Agreed-Upon Procedures Engagements That Address the Completeness, Mapping, Consistency, or Structure of XBRL-Formatted Information* (AICPA, *Professional Standards*, AUD sec. 55)
- SSAE No. 18, *Attestation Standards: Clarification and Recodification* (AICPA, *Professional Standards*)

Users of this guide should consider guidance issued subsequent to those items listed previously to determine their effect, if any, on entities covered by this guide. In determining the applicability of recently issued guidance, its effective date should also be considered.

The changes made to this edition of the guide are identified in the Schedule of Changes appendix. The changes do not include all those that might be considered necessary if the guide were subjected to a comprehensive review and revision.

Terms Used to Define Professional Requirements in This AICPA Guide

Any requirements described in this guide are normally referenced to the applicable standards or regulations from which they are derived. Generally, the terms used in this guide describing the professional requirements of the referenced standard setter (for example, the ASB) are the same as those used in the applicable standards or regulations (for example, *must* or *should*).

Readers should refer to the applicable standards and regulations for more information on the requirements imposed by the use of the various terms used to define professional requirements in the context of the standards and regulations in which they appear.

Certain exceptions apply to these general rules, particularly in those circumstances when the guide describes prevailing and preferred industry practices for the application of a standard or regulation. In these circumstances, the applicable senior committee responsible for reviewing the guide's content believes the guidance contained herein is appropriate for the circumstances.

Applicability of Quality Control Standards

QC section 10, *A Firm's System of Quality Control* (AICPA, *Professional Standards*), addresses a CPA firm's responsibilities for its system of quality control for its accounting and auditing practice. A system of quality control consists of policies that a firm establishes and maintains to provide it with reasonable assurance that the firm and its personnel comply with professional standards, as well as applicable legal and regulatory requirements. The policies also provide the firm with reasonable assurance that reports issued by the firm are appropriate in the circumstances.

QC section 10 applies to all CPA firms with respect to engagements in their accounting and auditing practice. In paragraph .13 of QC section 10, an *accounting and auditing practice* is defined as "a practice that performs engagements covered by this section, which are audit, attestation, compilation, review, and any other services for which standards have been promulgated by the AICPA ASB or the AICPA Accounting and Review Services Committee (ARSC) under the " General Standards Rule" (AICPA, *Professional Standards*, ET sec. 1.300.001) or the "Compliance With Standards Rule" (AICPA, *Professional Standards*, ET sec. 1.310.001) of the AICPA Code of Professional Conduct. Although standards for other engagements may be promulgated by other AICPA technical committees, engagements performed in accordance with those standards are not encompassed in the definition of an *accounting and auditing practice*."

In addition to the provisions of QC section 10, readers should be aware of other sections within AICPA *Professional Standards* that address quality control considerations, including the following provisions that address engagement level quality control matters for various types of engagements that an accounting and auditing practice might perform:

- AU-C section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*)
- AT-C section 105

- AR-C section 60, *General Principles for Engagements Performed in Accordance With Statements on Standards for Accounting and Review Services* (AICPA, *Professional Standards*)

Because of the importance of engagement quality, this guide includes an appendix, "Overview of Statements on Quality Control Standards." This appendix summarizes key aspects of the quality control standard. This summarization should be read in conjunction with QC section 10, AU-C section 220, AT-C section 105, and AR-C section 60, as applicable.

AICPA.org Website

The AICPA encourages you to visit its website at www.aicpa.org, the Governmental Audit Quality Center (GAQC) website at www.aicpa.org/GAQC, and the Financial Reporting Center at www.aicpa.org/FRC. The "GASB Matters" page on the GAQC website will be of particular interest to auditors of state and local governments.

The GAQC is a voluntary membership center for CPA firms and state audit organizations designed to improve the quality and value of governmental audits. For the purposes of the GAQC, governmental audits are performed under *Government Auditing Standards* and are audits and attestation engagements of federal, state, or local governments; not-for-profit entities; and certain for-profit organization, such as housing projects and colleges and universities that participate in governmental programs or receive governmental financial assistance. The GAQC website provides information and resources to those performing governmental audits.

The Financial Reporting Center supports members in the execution of high-quality financial reporting. Whether you are a financial statement preparer or a member in public practice, this center provides exclusive member-only resources for the entire financial reporting process and timely and relevant news, guidance, and examples supporting the financial reporting process. Another important focus of the Financial Reporting Center is keeping those in public practice up to date on issues pertaining to preparation, compilation, review, audit, attestation, assurance, and advisory engagements. Certain content on the AICPA's websites referenced in this guide may be restricted to AICPA members only.

Select Recent Developments Significant to This Guide

Attestation Clarity Project

To address concerns over the clarity, length, and complexity of its standards, the ASB established clarity drafting conventions and undertook a project to redraft all the standards it issues in clarity format. The redrafting of SSAEs in SSAE No. 18 represents the culmination of that process.

The attestation standards are developed and issued in the form of SSAEs and are codified into sections. SSAE No. 18 recodifies the "AT" section numbers designated by SSAE Nos. 10–17 using the identifier "AT-C" to differentiate the sections of the clarified attestation standards (AT-C sections) from the attestation standards that are superseded by SSAE No. 18 (AT sections).

The AT sections in AICPA *Professional Standards* remain effective through April 2017, by which time substantially all engagements for which the AT sections were still effective are expected to be completed. The clarified attestation standards found in AT-C sections are effective for practitioners' reports dated on or after May 1, 2017.

New OPEB Chapter

As noted earlier in the preface, chapter 14 is a new chapter in this year's edition of the guide that addresses accounting and auditing considerations for OPEB plans as a result of GASB Statement No. 74. The chapter also addresses accounting and auditing considerations for employers that provide OPEB administered through a trust that meets specified criteria and OPEB not administered through a qualifying trust as a result of GASB Statement No. 75. Note that given the later effective date of GASB Statement No. 75 (effective for periods beginning on or after June 15, 2017), the remainder of the guide references the current guidance in GASB Statement No. 45.

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Chapter 1

Overview and Introduction

Scope and Purpose

1.01 This Audit and Accounting Guide applies to all state and local governments.[1,2,3] Governmental organizations are subject to generally accepted accounting principles (GAAP) for state and local governments as described later in this chapter. Public corporations[4] and bodies corporate and politic are governmental organizations. Other organizations are governmental if they have one or more of the following characteristics:

- Popular election of officers or appointment (or approval) of a controlling majority of the members of the organization's governing body by officials of one or more state or local governments;
- The potential for unilateral dissolution by a government with the net assets reverting to a government; or
- The power to enact and enforce a tax levy.

Furthermore, organizations are presumed to be governmental if they have the ability to issue directly (rather than through a state or municipal authority) debt that pays interest exempt from federal taxation. However, organizations possessing only that ability (to issue tax-exempt debt) and none of the other governmental characteristics may rebut the presumption that they are governmental if their determination is supported by compelling, relevant evidence.

1.02 Organizations are governmental or nongovernmental for accounting, financial reporting, and auditing purposes based solely on the application of the preceding criteria; other factors are not determinative. For example, the fact that an entity is incorporated as a not-for-profit organization and exempt from federal income taxation under the provisions of IRC Section 501 is not

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[1] Auditing and accounting matters associated with the federal government are not within the scope of this guide. Throughout this guide, state and local governments may be referred to using the terms *governments* or *governmental entities*.

[2] Certain component units do not meet the definition of a government contained in this paragraph and, consequently, accounting, financial reporting, and auditing matters associated with the separate financial statements of those component units are not within the scope of this guide. However, accounting, financial reporting, and auditing matters associated with reporting component units, including nongovernmental component units, in a reporting entity's basic financial statements, required supplementary information (RSI), and supplementary information other than RSI (referred to as "*GASB defined*" *SI*; see chapter 2, "Financial Reporting") are within the scope of this guide. Chapter 3, "The Financial Reporting Entity," discusses GASB standards for defining and reporting component units.

[3] Other AICPA Audit and Accounting Guides also may be applicable to audits of certain governments. See paragraph 1.21.

[4] *Black's Law Dictionary* defines a *public corporation* as: "An artificial person (for example, [a] municipality or a governmental corporation) created for the administration of public affairs. Unlike a private corporation it has no protection against legislative acts altering or even repealing its charter. Instrumentalities created by [the] state, formed and owned by it in [the] public interest, supported in whole or part by public funds, and governed by managers deriving their authority from [the] state." *Sharon Realty Co. v. Westlake, Ohio Com. Pl., 188 N.E.2d 318, 323, 25, O.O.2d 322*. A public corporation is an instrumentality of the state, founded and owned in the public interest, supported by public funds and governed by those deriving their authority from the state. *York County Fair Ass'n v. South Carolina Tax Commission, 249 S.C. 337, 154 S.E.2d 361, 362*.

a criterion in determining whether an organization[5] is governmental or nongovernmental for accounting, financial reporting, and auditing purposes. Similarly, the fact that a pension plan that meets the definition of a *governmental organization* in paragraph 1.01 may be subject to the Employee Retirement Income Security Act of 1974 does not indicate that the pension plan should be considered nongovernmental for accounting, financial reporting, and auditing purposes.

1.03 Many tribes use governmental accounting and financial reporting guidance to prepare their financial statements, but some recognized Indian tribes may not meet the definition of *governmental organizations* in paragraph 1.01. A section of chapter 12, "Special-Purpose and State Governments," highlights the accounting, financial reporting, and auditing considerations relating to recognized Indian tribes.

1.04 There are over 90,000[6] recognized general- and special-purpose state and local governmental entities in the United States. *General-purpose governments* are governmental entities that provide a range of services, such as states, cities, counties, towns, and villages. *Special-purpose governments* are legally separate entities that perform only one activity or only a few activities. Special-purpose governments include, for example, cemetery districts, levee districts, assessment districts, drainage districts, school districts, utilities, hospitals or other health care organizations, public benefit corporations and authorities, public employee retirement systems, public colleges and universities, public transportation systems, airports, governmental external investment pools, and public entity risk pools.

1.05 An audit of a governmental entity may be conducted under four different groups of auditing standards or requirements:

a. Generally accepted auditing standards (GAAS)

b. The standards contained in *Government Auditing Standards* (also referred to as the Yellow Book), issued by the Comptroller General of the United States

c. The requirements of the Single Audit Act of 1984 and the Single Audit Act Amendments of 1996 (the Single Audit Act) and the Uniform Guidance[7]

d. Other auditing requirements, such as those required by a state oversight agency for audits of local governments

1.06 This guide discusses in detail the requirements for a financial statement audit encompassed by GAAS. Under AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*), this guide is an interpretive publication. That is, this guide provides guidance on the application of GAAS in a governmental environment. This guide also highlights the requirements for a financial audit encompassed by *Government Auditing*

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[5] This guide uses *governmental entity* and *governmental organization* interchangeably.

[6] U.S. Census Bureau, 2012 Census of Governments.

[7] The first three groups of audit standards and requirements are cumulative and progressive. That is, *Government Auditing Standards* incorporates and adds requirements to generally accepted auditing standards (GAAS), and the Single Audit Act incorporates and adds requirements to both *Government Auditing Standards* and GAAS.

Standards, referring where appropriate to the detailed discussion of those standards in the AICPA Audit Guide Government Auditing Standards *and Single Audits*. That guide provides detailed guidance on financial audits conducted in accordance with *Government Auditing Standards* as well as audits conducted in accordance with the Single Audit Act. Other auditing requirements are beyond the scope of GAAS and this guide and generally are not discussed in this guide.

1.07 This guide provides guidance for the audits of governmental financial statements that are prepared in accordance with GAAP[8] and is based on pronouncements issued or cleared by GASB. (See the following section for a discussion of GAAP for state and local governments.) This guide contains a small amount of category B accounting guidance, which is in orange font and listed in appendix B, "Category B Guidance."

1.08 The accounting and auditing guidance in this guide may become superseded by standards issued since its publication. Therefore, users of this guide should consider auditing and accounting pronouncements issued subsequent to this guide.

GAAP for State and Local Governments

1.09 Pursuant to the "Accounting Principles Rule" (AICPA, *Professional Standards*, ET sec. 1.320.001), the AICPA recognizes GASB as the standard-setting authority for GAAP for state and local governments. To provide accounting and financial reporting guidance for governmental entities, GASB has issued various statements and interpretations, and its staff has issued various technical bulletins and implementation guides.

1.10 GASB Statement No 76, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*, defines the sources of accounting principles used in the preparation of financial statements of state and local governmental entities that are presented in conformity with GAAP, and the framework for selecting those principles. GASB Statement No. 76 categorizes the sources of authoritative GAAP, in descending order of authority, as follows:

a. Officially established accounting principles—GASB statements[9]

b. GASB Technical Bulletins, GASB Implementation Guides, and literature of the AICPA specifically cleared by GASB[10]

1.11 Under GASB Statement No. 76, if the accounting treatment for a transaction or other event is not specified by a pronouncement in category A, a governmental entity should consider whether the accounting treatment is specified by an accounting principle from a source in category B. In such cases, if category B contains an accounting principle that specifies the accounting treatment for a transaction or other event, the governmental entity should follow the

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[8] Chapters 16, "Audit Reporting," and 17, "Financial Statements Prepared in Accordance With a Special-Purpose Framework," also discuss auditor's reports on summary financial information (popular reports) and on financial statements prepared in accordance with a special-purpose framework.

[9] GASB Statement No. 76, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*, establishes that all GASB interpretations previously issued and currently in effect are also included in category A generally accepted accounting principles until altered, amended, supplemented, revoked, or superseded by subsequent GASB pronouncements.

[10] See paragraph 1.07 and paragraph 1.20.

accounting treatment specified by that accounting principle. If the accounting treatment for a transaction or other event is not specified by a pronouncement as described in category A or category B, a governmental entity should consider accounting principles for similar transactions or other events within category A or category B and then may consider nonauthoritative accounting literature. Sources of nonauthoritative accounting literature include the following:

- GASB Concepts Statements
- Pronouncements and other literature of FASB
- Pronouncements and other literature of the Federal Accounting Standards Advisory Board
- Pronouncements and other literature of the International Public Sector Accounting Standards Board
- Pronouncements and other literature of the International Accounting Standards Board
- Other AICPA literature not cleared by GASB
- Practices that are widely recognized and prevalent in state and local government
- Literature of other professional associations or regulatory agencies
- Accounting textbooks, handbooks, and articles

1.12 The appropriateness of nonauthoritative accounting literature depends on its relevance to particular circumstances, the specificity of the guidance, and the general recognition of the issuer or author as an authority. A governmental entity should not follow the accounting treatment specified in accounting principles for similar transactions or other events in cases in which those accounting principles either prohibit the application of the accounting treatment to the particular transaction or other event or indicate that the accounting treatment should not be applied by analogy.

1.13 References in this guide to discussions or examples in the nonauthoritative appendixes of GASB pronouncements or its staff's implementation guides do not elevate that guidance from *nonauthoritative accounting literature*.

1.14 The "Accounting Principles Rule" prohibits an auditor from expressing an unmodified opinion if the financial statements contain a material departure from accounting principles promulgated by a body designated by the AICPA Council to establish such principles (that is, category [*a*] guidance) unless, due to unusual circumstances, adherence to the pronouncements would make the statements misleading. The "Accounting Principles Rule" states that the application of officially established accounting principles almost always results in the fair presentation of financial position, results of operations, and cash flows in conformity with GAAP. Nevertheless, the "Accounting Principles Rule" provides for the possibility that the literal application of such a pronouncement might, in unusual circumstances, result in misleading financial statements. In such a situation, the "Accounting Principles Rule" requires the auditor's report on the financial statements to describe the departure, its approximate effects, if practicable, and the reasons why compliance with the principle would result in a misleading statement. (See paragraph .A15 of AU-C section 700, *Forming an Opinion and Reporting on Financial Statements* [AICPA, *Professional Standards*].) The auditor's report should indicate the opinion units affected by the departure. (See the discussion of opinion units and their effect on the auditor's report in chapter 4, "General Auditing Considerations," and chapter 16, "Audit Reporting.")

Applicable Auditing Standards and Requirements

1.15 Auditors who conduct audits of governmental financial statements should comply with all AU-C sections relevant to the audit. An AU-C section is relevant to the audit when the AU-C section is in effect and the circumstances addressed by the AU-C section exist. Auditors also should be aware of and consider applicable interpretative publications that provide recommendations on the application of GAAS—Audit and Accounting Guides, Statements of Positions (SOPs), and Auditing Interpretations. AU-C section 935, *Compliance Audits* (AICPA, *Professional Standards*), is also relevant if the audit of the state or local government includes a compliance audit.

1.16 AU-C section 935 is applicable when an auditor is engaged, or required by law or regulation, to perform a compliance audit in accordance with all of the following:

- GAAS
- The standards for financial audits under *Government Auditing Standards*
- A governmental audit requirement that requires an auditor to express an opinion on compliance

See chapter 4 for a discussion about considering the requirements of AU-C section 935 while planning the audit.[11]

1.17 In addition to GAAS, auditors of state and local governmental entities also may need to comply with *Government Auditing Standards*. Those standards are to be followed by auditors and audit organizations when required by laws, regulations, contracts, grant agreements, or policies or when auditors voluntarily choose to perform their work in accordance with *Government Auditing Standards*. For financial audits,[12] *Government Auditing Standards* incorporates all AICPA auditing standards by reference. Additional *Government Auditing Standards* requirements and guidance relating to financial audits are discussed in the AICPA Audit Guide Government Auditing Standards *and Single Audits*.

1.18 The Single Audit Act, as amended, imposes additional audit responsibilities on auditors of certain state and local governments that expend federal awards. The OMB is the federal agency that has primary responsibility for implementing the Single Audit Act and the Uniform Guidance set forth audit requirements for single audits. A supporting OMB document, the *OMB Compliance Supplement*, which is updated annually, identifies the significant

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[11] Auditors also may be engaged to provide attest services—an engagement to express a conclusion on subject matter, or an assertion about the subject matter, that is the responsibility of another party. Those engagements are conducted in accordance with AICPA Statements on Standards for Attestation Engagements and generally are not within the scope of this guide.

[12] Besides financial audits, *Government Auditing Standards* also addresses attestation engagements and performance audits. Chapter 2 of *Government Auditing Standards* defines financial audits, attestation engagements, and performance audits.

compliance requirements to be considered in single audits and certain program-specific audits. Audits under the provisions of the Uniform Guidance are discussed in the AICPA Audit Guide Government Auditing Standards *and Single Audits*.

1.19 Auditors of governmental entities, or of specific governmental grants, programs, or contracts, should have an understanding of the auditing requirements that affect the scope of the engagement. That understanding should include those requirements promulgated by state or local governments or federal agencies that have oversight authority over the government or are responsible for administering the specific grants, programs, or contracts.

1.20 The "Governmental Audits" interpretation under the "Acts Discreditable Rule" (AICPA, *Professional Standards*, ET sec. 1.400.055) states:

> If a member ... undertakes an obligation to follow specified government audit standards, guides, procedures, statutes, rules, and regulations, in addition to generally accepted auditing standards, he or she is obligated to follow such requirements. Failure to do so is an act discreditable to the profession in violation of the "Acts Discreditable Rule" of the AICPA Code of Professional Conduct, unless the auditor discloses in his or her report the fact that such requirements were not followed and the reason therefore.

Guidance in Other AICPA Audit and Accounting Guides and Statements of Position

1.21 This guide is not the only industry-specific AICPA Audit and Accounting Guide that auditors might have to consider when performing an audit of a governmental entity. Two other industry-specific guides include accounting guidance for governmental entities that has been cleared by GASB. Those guides are *Health Care Entities* and *Gaming*. The accounting and financial reporting guidance in those guides that has been cleared by GASB constitutes category B guidance for the applicable governmental entities, and the auditing guidance in those guides also should be considered during an audit of those governmental entities. (See the further discussions concerning the application of these guides to those governmental entities in the sections of chapter 12 titled "Hospitals and Other Health Care Providers" and "Specific Guidance for Indian Tribes.") Further, the AICPA Audit Guide Government Auditing Standards *and Single Audits* may apply to the audits of governmental entities. (See the discussion in paragraph 1.06.) In addition, SOP 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising* (AICPA, *Professional Standards*, ACC sec. 10), includes governmental entities in its scope and was cleared by GASB and, thus, is category B accounting and financial reporting guidance for governmental entities. (That SOP is included as the supplement to this guide.)

1.22 Other AICPA Audit and Accounting Guides may provide useful suggested auditing procedures if a governmental entity is in a specialized industry or has transactions addressed by this literature, even though governmental entities are not included in their scope. Among those guides are *Brokers and Dealers in Securities*; *Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies, and Mortgage Companies*; *Employee Benefit Plans*; *Investment Companies*; *Special Considerations in*

Auditing Financial Instruments; *Assessing and Responding to Audit Risk in a Financial Statement Audit*; *Not-for-Profit Entities*; and *Property and Liability Insurance Entities*. Although not cleared by GASB or made specifically applicable to governmental entities, accounting guidance in these guides may be useful as "nonauthoritative accounting literature" in a particular situation, provided it does not conflict with or contradict authoritative governmental GAAP.

Other Sources of Guidance

1.23 The following AICPA publications contain guidance that may be useful in conducting audits of governmental financial statements. Under AU-C section 200 these are *other auditing publications* and, although they might be useful, auditors are not required to consider them.

- The AICPA annually issues the Audit Risk Alert Government Auditing Standards *and Single Audit Developments* as a complement to the Audit Guide Government Auditing Standards *and Single Audits*, Audit Risk Alert *General Accounting and Auditing Developments*, and other Audit Risk Alerts as complements to other guides (such as some of the other guides mentioned in paragraphs 1.21–.22) that may be useful in conducting audits of governmental financial statements.
- The AICPA has various publications to assist with financial statement audits of state and local governmental entities. For example, *Applying Special Purpose Frameworks in State and Local Governmental Financial Statements*[13] provides guidance on preparing and reporting on financial statements prepared in accordance with a special-purpose framework.

Organization of This Guide

1.24 This guide is organized as follows:

- Chapter 2, "Financial Reporting," and chapter 3, "The Financial Reporting Entity," provide an overview of the accounting and financial reporting requirements for state and local governments, including the activities and financial statements that should be included in their basic financial statements and the required supplementary information that should accompany those financial statements.
- Chapter 4 provides guidance on various considerations relating to planning the audit, such as materiality, internal control, and compliance requirements that may affect the audit, and communications with the auditee.
- Chapter 5, "Investments, Certain Equity Interests, and Derivatives," through chapter 10, "Net Position and Financial Statement Reconciliations," discuss, for various accounts in the financial

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[13] Preparers and auditors could consider reviewing the AICPA's Practice Aid *Applying Special Purpose Frameworks in State and Local Governmental Financial Statements*, which is available for purchase at www.AICPAStore.com. Although nonauthoritative, this publication has been reviewed by subject-matter experts and represents best practice guidance.

position and activity statements,[14] the nature of the transactions; accounting and financial reporting considerations; and auditing considerations, including audit objectives, internal control features, and audit procedures.

- Chapter 11, "The Budget," discusses the effect of a government's budget on its activities, financial reporting, and audit.
- Chapter 12 highlights accounting, financial reporting, and auditing considerations relating to special-purpose, Indian tribal, and state governments.
- Chapter 13, "Defined Benefit Pension Plans (Plan & Employer Considerations)," highlights accounting, financial reporting, and auditing considerations relating to pension plans and participating employers.
- Chapter 14, "Defined Benefit Postemployment Benefits Other Than Pensions (Plan & Employer Considerations)," highlights accounting, financial reporting, and auditing considerations relating to other postemployment benefits and plans other than pensions.
- Chapter 15, "Concluding the Audit," and chapter 16 present various considerations relating to finalizing the audit and the auditor's reports on financial statements.
- Chapter 17, "Financial Statements Prepared in Accordance With a Special-Purpose Framework," discusses the financial statements and auditor's reports on governmental financial statements prepared in accordance with a special-purpose framework.
- Chapter 18, "Auditor Involvement With Municipal Securities Filings," discusses the auditor's involvement with a government's official statements and continuing disclosure documents for debt issuances.

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[14] This guide sometimes uses the term *financial position statements* in a generic manner to refer to one or more of the following—the government-wide statement of net position, the governmental funds balance sheet, the proprietary funds statement of fund net position or balance sheet, and the fiduciary funds statement of fiduciary net position. This guide sometimes uses the term *activity statements* in a generic manner to refer to one or more of the following—the government-wide statement of activities, the governmental funds statement of revenues, expenditures, and changes in fund balances, the proprietary funds statement of revenues, expenses, and changes in fund net position, and the fiduciary funds statement of changes in fiduciary net position. Those financial statements are discussed in chapter 2.

Chapter 2

Financial Reporting

There are similarities, but important differences, between how GASB defines supporting information and how the AICPA auditing standards refer to that same information. The following is intended to clarify the two standard-setters' descriptions of the information and how the information will be referred to in this guide.

According to GASB Concepts Statement No. 3, *Communication Methods in General Purpose External Reports That Contain Basic Financial Statements*, supporting information places basic financial statements and notes to basic financial statements in an appropriate operational, economic or historical context. The information is either (1) required by GASB as required supplementary information (RSI) to be presented with the basic financial statements and the notes thereto; (2) supplementary information (SI), which is required by law or regulation to be presented; or (3) SI presented at the election of the preparer. SI as contemplated in GASB Concepts Statement No. 3 (preceding items 2–3) are referred to in this guide when describing GASB requirements as *"GASB defined" SI*. GASB Concepts Statement No. 3 limits its discussion of supporting information to "GASB defined" SI and RSI.

In contrast, the AICPA auditing standards refer to such supporting information as either RSI, other information (OI), or SI. AU-C section 730, *Required Supplementary Information* (AICPA, *Professional Standards*), defines RSI consistently with GASB literature. Therefore, references to such information in this guide are to RSI. AU-C section 720, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*), defines OI as financial and nonfinancial information (other than the financial statements and the auditor's report thereon) that is included in a document containing audited financial statements and the auditor's report thereon, excluding RSI. AU-C section 725, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*), defines SI as information presented outside the basic financial statements, excluding RSI that is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. This guide uses SI to describe information for which (1) the required conditions in AU-C section 725 have been met and (2) the auditor has been engaged to provide an "in relation to" opinion and OI for situations where the limited procedures in AU-C section 720 are required.

Introduction and Overview

2.01 According to AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*), the financial accounting standards promulgated by GASB are recognized to be used by U.S. state and local governmental entities for preparing financial statements in accordance with a general purpose framework. Governments have unique requirements for financial reporting—that is, how they present information in their basic financial statements (including the notes to those financial statements) and RSI. This chapter provides an overview of the basic financial statements and RSI required by GASB standards and discusses certain auditing considerations relating to them. It also discusses in detail certain GASB standards and the supplementary information other than RSI, referred to in this guide as "GASB defined" SI, which some governments present with their basic financial statements. Other chapters in this guide provide additional details about the accounting, financial reporting, and auditing considerations for the basic financial statements and RSI.

Historical Perspective

2.02 The required structure and presentation of information in a government's basic financial statements is known as *the financial reporting model*. For many years, and with the issuance in 1979 of National Council on Governmental Accounting (NCGA) Statement 1, *Governmental Accounting and Financial Reporting Principles*, generally accepted accounting principles (GAAP) have required governments to present their financial statements using a funds structure. When it was created in 1984, GASB agreed that, among other projects, it would reexamine the financial reporting model. Later, GASB agreed also to consider the financial reporting model for public colleges and universities. GASB's efforts resulted in the issuance in 1999 of GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, and No. 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities—an amendment of GASB Statement No. 34*. Since 1999, GASB has issued several statements that amend provisions of GASB Statement Nos. 34 and 35.

2.03 The nonauthoritative "Basis for Conclusions" of GASB Statement No. 34, as amended, explains GASB's reasoning for the required financial presentation, which builds on the traditional, fund-based financial reporting model. GASB believes that the financial reporting model required by GASB Statement No. 34, as amended, provides understandable and useful information to financial statement users within the context of two types of accountability—fiscal accountability and operational accountability. GASB defines *fiscal accountability* as the responsibility of governments to justify that their actions in the current period have complied with public decisions concerning the raising and spending of public moneys in the short term. *Operational accountability* is governments' responsibility to report the extent to which they have met their operating objectives efficiently and effectively, using all resources available for that purpose, and whether they can continue to meet their objectives for the foreseeable future.

2.04 GASB Concepts Statement No. 4, *Elements of Financial Statements*, establishes definitions for the seven elements of historically based financial statements prepared by state and local governments. This concept statement identifies and defines five elements for a government's statement of financial position and two elements for a government's resource flows statements. Central to all definitions is the concept of "resource," which, in the context of a government, is an item that it can draw on to provide services to its citizenry. Definitions are based primarily on the inherent characteristics of each element, apply to an entity that is a governmental unit (legal entity) and are applicable to any measurement focus under which financial statements may be prepared.

2.05 Elements of a government's statement of financial position are as follows:

Assets. Resources with present service capacity the government presently controls.

Deferred outflow of resources. Consumption of net assets by the government that is applicable to a future reporting period.

Liabilities. Present obligations to sacrifice resources that the government has little or no discretion to avoid.

Deferred inflow of resources. Acquisition of net assets by the government that is applicable to a future reporting period.

Net position. Residual of all other elements presented in the statement of financial position.

2.06 Elements of the resource flows statements are as follows:

Outflow of resources. Consumption of net assets by the government that is applicable to the reporting period.

Inflow of resources. Acquisition of net assets by the government that is applicable to the reporting period.

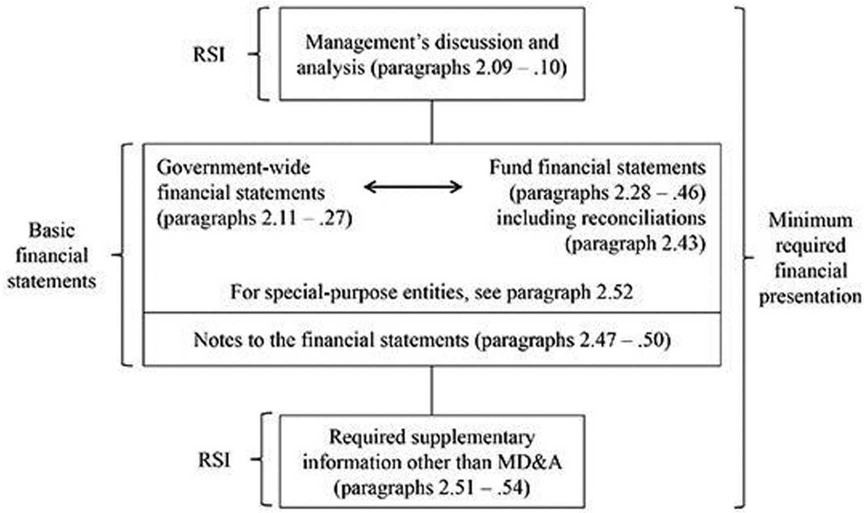
Governmental Financial Statements

2.07 The principal GASB pronouncements establishing standards for the form and content of the basic financial statements to be issued by all state and local governmental entities are GASB Statement No. 34, as amended, and GASB Statement No. 35 for public colleges and universities. Additional guidance is provided in the GASB *Implementation Guide No. 2015-1* (GASB IG 2015-1), particularly in paragraph 13. Various nonauthoritative illustrations of the financial statement presentation and note disclosure requirements of GASB Statement No. 34, as amended, are in an appendix to GASB Statement No. 34 and Appendix B7 to the GASB IG 2015-1. Various other NCGA and GASB pronouncements also address the form and content of governmental financial statements, including note disclosures. Various GASB pronouncements and other paragraphs of the GASB IG 2015-1 address and illustrate the form and content of the RSI that accompanies the basic financial statements. This section of this chapter discusses the presentation of the basic financial statements and RSI; other chapters in this guide provide more detail about certain aspects of those financial statements and RSI.

2.08 The minimum required financial presentation for governments is composed of three sections: (*a*) management's discussion and analysis (MD&A), which is RSI, (*b*) the basic financial statements, and (*c*) RSI other than MD&A. For many governments, the basic financial statements have three sections: (1) government-wide financial statements, (2) fund financial statements, and (3) notes to the financial statements. Exhibit 2-1 includes a graphical representation of the minimum required financial presentation, with cross-references to related paragraphs in this chapter.

Exhibit 2-1

Minimum Required Financial Presentation



Management's Discussion and Analysis

2.09 MD&A is RSI that introduces the basic financial statements by presenting certain financial information as well as management's analytical insights on that information. That analysis should provide users with the information they need to help them assess whether the government's financial position has improved or deteriorated as a result of the year's operations. Paragraphs 8–11 of GASB Statement No. 34, as amended, provide the standards for MD&A, which should precede the basic financial statements. The information to be presented in MD&A should be confined to the topics discussed in GASB Statement No. 34 paragraph 11, as amended, summarized as follows:

a. A brief discussion of the basic financial statements, including the relationships of the statements to each other, and the significant differences in the information they provide

b. Condensed financial information derived from the government-wide financial statements comparing the current year to the prior year, including certain specific elements listed in GASB Statement No. 34 paragraph 11b, if relevant[1]

c. An analysis of the government's overall financial position and results of operations to assist users in assessing whether financial position has improved or deteriorated as a result of the year's operations

d. An analysis of balances and transactions of individual funds[2]

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[1] GASB *Implementation Guide No. 2015-1* (GASB IG 2015-1) questions 7.5.4 and 7.5.6 provide guidance related to management's discussion and analysis when comparative financial statements are presented.

[2] GASB IG 2015-1 question 7.5.8 states that the analysis of balances and transactions of individual funds would normally be confined to major funds. Nevertheless, governments can discuss transactions or significant changes in account balances of nonmajor funds.

e. An analysis of significant variations between original and final budget amounts and between final budget amounts and actual budget results for the general fund (or its equivalent)

f. A description of significant capital asset and long-term debt activity during the year

g. Specific information by governments that use the modified approach to report some or all of their infrastructure assets

h. A description of currently known facts, decisions, or conditions that are expected to have a significant effect on financial position or results of operations

Currently known indicates information that management is aware of as of the date of the auditor's report. As clarified in GASB IG 2015-1 question 7.5.13, the MD&A discussions should be based on events or decisions that already have occurred, or have been enacted, adopted, agreed upon, or contracted. Governments should not discuss the possible effect of potential future events or decisions. (See the examples of items that are and are not currently known facts, decisions, or conditions in GASB IG 2015-1 question 7.5.13.) Further, because the information to be presented in MD&A should be confined to specific topics, governments should not present in MD&A any topics other than those discussed in GASB Statement No. 34 paragraph 11, as amended.

2.10 MD&A should focus on the primary government and distinguish between information pertaining to the primary government and its component units. Discussing matters relating to component units in MD&A is a matter of professional judgment, as discussed in chapter 3, "The Financial Reporting Entity." (RSI other than MD&A is discussed in paragraphs 2.49–.52.)

Government-Wide Financial Statements

2.11 The government-wide financial statements are highly aggregated financial statements that present financial information for all assets (including capital assets), deferred outflows of resources, liabilities, deferred inflows of resources, and net position of a primary government and its component units,[3] except for fiduciary funds.[4] The government-wide financial statements use the economic resources measurement focus and accrual basis of accounting. Those financial statements are designed to help users assess the finances of the government in its entirety, including the year's operating results; determine whether the government's overall financial position improved or deteriorated; and evaluate whether the government's current-year revenues were sufficient to pay for current-year services. They also are designed to help users assess the cost of providing services to its citizenry; determine how the government finances its programs—through user fees and other program revenues versus

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[3] Primary governments and component units are legally separate entities that are included together in a financial reporting entity's financial statements. See the discussion in chapter 3, "The Financial Reporting Entity."

[4] GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, provides that component units that are fiduciary in nature are displayed with fiduciary funds in the fiduciary fund financial statements. This guide uses the term *fiduciary funds* to refer not only to a primary government's fiduciary funds but also to its component units that are fiduciary in nature. See also GASB IG 2015-1 question 4.27.1, which clarifies that there are three types of component units—blended, discretely presented, and fiduciary. This guide refers to component units that are not fiduciary in nature as blended component units or discretely presented component units.

general tax revenues; understand the extent to which the government has invested in capital assets, including roads, bridges, and other infrastructure assets; and make better comparisons between governments.

2.12 Paragraphs 12–62 of GASB Statement No. 34, as amended, provide the standards for the government-wide financial statements. The government-wide financial statements are the statement of net position and the statement of activities. The statements should

- include the primary government and its component units, except for fiduciary funds.
- use separate rows and columns to distinguish between the total primary government (including its blended component units) and its discretely presented component units.
- use separate rows and columns to distinguish between the primary government's governmental and business-type activities. Governmental activities generally are financed through taxes, intergovernmental revenues, and other nonexchange revenues and usually are reported in governmental funds and internal service funds.[5] Business-type activities are financed in whole or in part by fees charged to external parties for goods or services and usually are reported in enterprise funds.[6] (See the discussion of fund classifications starting at paragraph 2.28.)
- present total columns for the primary government. A total column for the entity as a whole may be presented but is not required. Prior-year data may be presented in the government-wide financial statements but also are not required. (See the further discussion of prior-period comparative financial information at paragraphs 2.55–.56.)

2.13 The government-wide financial statements should use the economic resources measurement focus and accrual basis of accounting. They should recognize the effect of exchange and exchange-like transactions when the exchange takes place. They should recognize the effect of nonexchange transactions in accordance with the requirements of GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, as amended.

2.14 Paragraph 76 of GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, as amended, provides that changes in accounting principles should be recognized by adjusting the beginning net position/fund

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[5] Internal service fund assets, deferred outflows of resources, liabilities, and deferred inflows of resources balances that are not eliminated in the statement of net position normally should be reported in the governmental activities column. (See chapter 9, "Interfund, Internal, and Intra-Entity Activity and Balances," concerning the eliminations of interfund activities and balances.) However, if enterprise funds are the predominant or only participants in an internal service fund, that internal service fund's residual assets, deferred outflows of resources, liabilities, and deferred inflows of resources should be reported within the business-type activities column in the statement of net position.

[6] GASB IG 2015-1 question 7.7.4 indicates that the statement of activities usually follows the categorizations used in the fund financial statements—governmental activities are those that usually are accounted for in governmental funds, and business-type activities are those that usually are accounted for in enterprise funds. However, governments can realign their activities if they believe that it more faithfully represents their operating objectives and philosophies. The reconciliations from the governmental and enterprise fund financial statements to the government-wide statements, as discussed in paragraph 2.44, would explain the reclassification.

net position in the period of the change for the cumulative effect of changing to the new accounting principle.[7] However as addressed in paragraphs 86–87 of GASB Statement No. 62, as amended, a change in reporting entity should be reported by restating the financial statements of prior periods.

Statement of Net Position

2.15 GASB Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*, provides guidance for reporting net position within a framework that includes deferred outflows of resources and deferred inflows of resources, in addition to assets and liabilities. Net position represents the difference between all other elements in a statement of financial position. The statement of net position should report the residual amount as net position, rather than net assets, proprietary or fiduciary fund balance, or equity.

2.16 The statement of net position should report all financial and capital resources, including infrastructure and intangible capital assets, except that certain capital assets need not be capitalized, such as certain collections of works of art. (Chapter 7, "Capital Assets," discusses the accounting, financial reporting, and auditing considerations for capital assets.) The statement of net position is the only financial statement that reports general capital assets and general long-term liabilities, which are capital assets and long-term liabilities that are not specifically related to activities reported in proprietary or fiduciary funds and that are associated with and generally arise from governmental activities.

2.17 Governments are encouraged to present the statement of net position in a format that displays assets, plus deferred outflows of resources, less liabilities, less deferred inflows of resources, equals net position; however, they may use the traditional balance-sheet format (assets plus deferred outflows of resources equals liabilities plus deferred inflows of resources, plus net position). Regardless of the format used, the statement should label the difference between assets plus deferred outflows of resources and liabilities plus deferred inflows of resources as net position and display it in three components: (1) "net investment in capital assets," (2) "restricted" (distinguishing between major categories of restrictions), and (3) "unrestricted." Chapter 10, "Net Position and Financial Statement Reconciliations," discusses the financial reporting and auditing considerations for net position (net position and fund balances), and explains the differences between the net position amounts and components reported in the various financial statements.

2.18 GASB Statement No. 34, as amended, encourages governments to present assets and liabilities in the statement of net position in order of their relative liquidity. An asset's liquidity should be determined by how readily it is expected to be converted to cash and whether restrictions limit the government's ability to use the resources.[8] A liability's liquidity is based on its maturity, or when cash is expected to be used to liquidate it. The liquidity of an asset

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[7] Paragraph 52 of GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, requires that information be furnished in the notes to the financial statements to explain any changes that have occurred in the manner of or basis for presenting corresponding items for two or more periods when comparative financial statements are presented.

[8] GASB IG 2015-1 question 7.22.3 discusses how the reporting of restricted assets under the "order of liquidity" approach is based on the time length of the restriction.

or liability may be determined by assessing the average liquidity of the class of assets or liabilities to which it belongs, even though individual balances may be significantly more or less liquid than others in the same class and some items may have both current and long-term elements. Liabilities whose average maturities are greater than one year should be reported in two components—the amount due within one year and the amount due in more than one year.[9] Alternatively, governments may present a classified statement of net position, which distinguishes between all current and long-term assets and liabilities using the classification provisions provided in GASB Statement No. 62 as amended (see chapter 8, "Expenses or Expenditures and Liabilities," for a discussion of the classification of short term obligations expected to be refinanced). Furthermore, assets and liabilities should not be offset in the statement of net position except where a right of offset exists.

2.19 Amounts that are required to be reported as deferred outflows of resources should be reported in a statement of financial position in a separate section following assets. Similarly, amounts that are required to be reported as deferred inflows of resources should be reported in a separate section following liabilities. The netting of deferred outflows of resources and deferred inflows of resources generally is not permitted. However, the total for deferred outflows of resources may be added to the total for assets, and the total for deferred inflows of resources may be added to the total for liabilities to provide subtotals.

2.20 Balances of deferred outflows of resources and deferred inflows of resources reported in a statement of net position or a governmental fund balance sheet may be aggregations of different types of deferred amounts. If significant components of the total deferred amounts are obscured by aggregation, governments should provide details of the different types of deferred amounts in the notes to the financial statements. If a component of net position is significantly affected by deferred outflows of resources and deferred inflows of resources, an explanation of the effect of the deferred amounts on the net position component should be provided in the notes to the financial statements. Because liquidity concepts do not apply to deferred inflows of resources and outflows of resources, those financial statement elements are not classified as current or noncurrent.

Deferred Outflows of Resources and Deferred Inflows of Resources

2.21 According to GASB Concepts Statement No. 4, recognition of deferred outflows of resources and deferred inflows of resources should be limited to those instances identified by GASB in authoritative pronouncements. The following list includes those instances identified by GASB in authoritative pronouncements:

- GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, as amended, requires the reporting of a deferred outflow of resources or a deferred inflow of resources for the changes in fair value of hedging derivative instruments.
- GASB Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements*, as amended, may require a deferred inflow of resources to be reported by a transferor

[9] GASB IG 2015-1 question 7.22.4 discusses how governments should determine when compensated absences are "due." GASB IG 2015-1 question Z.16.2 focuses on recognition for governmental funds and clarifies that compensated absences should be reported in governmental funds when matured (due and payable), not when such compensated absences vest.

government in a qualifying service concession arrangement, based on facts and circumstances.

- GASB Statement No. 65, *Items Previously Reported as Assets and Liabilities*, limits use of the term *deferred* to items reported as deferred outflows of resources or deferred inflows of resources and identifies specific items as deferred inflows of resources and deferred outflows of resources.
- GASB Statement No. 68, *Accounting and Financial Reporting for Pensions, an amendment of GASB Statement No. 27*, as amended, includes the reporting of deferrals such as requiring certain changes in the net pension liability to be reported as deferred outflows of resources or deferred inflows of resources related to pensions. Additionally, employer pension contributions during the reporting period made subsequent to the measurement date of the net pension liability are to be reported as deferred outflows of resources.
- GASB Statement No. 69, *Government Combinations and Disposals of Government Operations*, describes accounting for deferred outflows of resources and deferred inflows of resources in transactions involving government combinations and disposals of government operations.
- GASB Statement No. 73, *Accounting and Financial Reporting for Pensions and Related Assets That Are Not Within the Scope of GASB Statement 68, and Amendments to Certain Provisions of GASB Statements 67 and 68*, includes the reporting of deferrals such as requiring certain changes in the total pension liability to be reported as deferred outflows of resources or deferred inflows of resources related to pensions. Additionally, amounts paid by the employer for pensions as the benefits come due subsequent to the measurement date of the total pension liability, and amounts for pension administrative expenses incurred subsequent to the measurement date of the total pension liability are required to be reported as deferred outflows of resources.
- GASB Statement No. 81, *Irrevocable Split-Interest Agreements*, requires that a government's unconditional interest in an irrevocable split-interest agreement be recognized as a deferred inflow of resources when the government is both the intermediary and either the lead or remainder interest beneficiary.

Update 2-1 *Deferred Outflows of Resources and Deferred Inflows of Resources*

GASB Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*, requires that changes in the net or total postemployment benefits other than pensions (OPEB) liability, as applicable, that have not been included in OPEB expense are required to be reported as deferred outflows of resources or deferred inflows of resources related to OPEB. Additionally, for circumstances in which OPEB is provided through an OPEB plan that is administered through a trust that meets the specified criteria, employer OPEB contributions made subsequent to the measurement date of the net OPEB liability and before the end of the reporting period are required to be reported as deferred outflows of resources. For circumstances in which OPEB is provided through an OPEB plan that is not administered through a trust that meets the specified criteria, amounts paid by the employer for OPEB as the benefits come due subsequent to the measurement date of the total OPEB liability and before the end of the reporting period, and amounts for OPEB administrative expenses incurred subsequent to the measurement date of the total OPEB liability and before the end of the reporting period, are required to be reported as deferred outflows of resources.

The statement was issued in June 2015 and is effective for fiscal years beginning after June 15, 2017. Earlier application is encouraged.

Those implementing GASB Statement No. 75 may refer to chapter 14, "Defined Benefit Postemployment Benefits Other Than Pensions (Plan & Employer Considerations)," for guidance related to accounting and reporting for OPEB plans under the new statement.

GASB Statement No. 83, *Certain Asset Retirement Obligations*, requires a government that has legal obligations to perform future asset retirement activities related to its tangible capital assets to recognize a liability and a corresponding deferred outflow of resources.

GASB Statement No. 83 was issued in November 2016 and is effective for reporting periods beginning after June 15, 2018.

The full texts of both statements are available on GASB's website at www.gasb.org.

Statement of Activities

2.22 GASB Statement No. 34, as amended, requires the statement of activities to present activities accounted for in governmental funds at a minimum by function and activities accounted for in enterprise funds at a minimum by different identifiable activities. NCGA Statement 1, as amended, defines a function as a group of related activities that is aimed at accomplishing a major service or regulatory responsibility (such as public safety, public works, and education). GASB Statement No. 37, as amended, states that an activity within an enterprise fund is *identifiable* if it has a specific revenue stream and related expenses and gains and losses that are accounted for separately. Determining whether an activity is *different* generally is based on the goods, services, or programs provided by an entity, but may require the use of professional judgment. For example, providing natural gas differs from supplying water or electricity, although all three are utility services. Conversely, separate water districts are not "different" activities, although they may serve different areas.[10] GASB Statement No. 34, as amended, and this guide use the term *function* to refer to the level of detail presented in the statement of activities for both governmental and business-type activities. GASB Statement No. 34, as amended, encourages governments to provide data in the statement of activities at a more detailed level than by function if doing so provides more useful information without significantly reducing the statement's understandability.

2.23 A government should present its statement of activities in a format that reports the net (expense) revenue (also known as *net cost*) of its individual functions. That format identifies the extent to which each function's

[10] GASB IG 2015-1 questions 7.26.3–7.26.5 and paragraph 2.22 of this guide discuss situations in which activities accounted for in enterprise funds are different identifiable activities.

expenses (except those that meet the definition of special or extraordinary items or transfers) are self-financing through program revenues—which are charges for services and restricted grants and contributions—or instead draw from the government's general revenues. General revenues,[11] contributions to term and permanent endowments, contributions to permanent fund principal, special and extraordinary items, and transfers should be reported separately after the total net expenses of the government's functions, ultimately arriving at the "change in net position" for the period. GASB Statement No. 34 paragraph 54 provides an example of a format that meets those requirements. (Certain special-purpose governments may modify the standard format of the statement of activities or use an alternative format; see chapter 12, "Special-Purpose and State Governments.")

2.24 Chapter 8 explains how expenses are classified into the various functions or as special or extraordinary items. Chapter 7 discusses the measurement and reporting of depreciation expense on capital assets, including amortization of intangible assets. Chapter 6, "Revenues and Receivables," explains how resource inflows are classified as program revenues, general revenues, contributions to term and permanent endowments, contributions to permanent fund principal, and special and extraordinary items.

Internal and Intra-Entity Activity and Balances

2.25 In aggregating data for the statement of net position and the statement of activities, some amounts reported as interfund activity and balances in the fund financial statements should be eliminated or reclassified. Chapter 9, "Interfund, Internal, and Intra-Entity Activity and Balances," explains those eliminations and reclassifications. That chapter also explains how activities and balances between the primary government and its component units should be reported.

Fund Financial Statements

2.26 The fund financial statements consist of a series of statements that focus on information about the government's major governmental and enterprise funds as well as its internal service and fiduciary funds. Those financial statements present additional and detailed information about the activities in the primary government's governmental and proprietary funds, including its blended component units. In addition, those statements provide the only presentation in the basic financial statements for the activity and balances of fiduciary funds. The financial statements for the three fund categories—governmental, proprietary, and fiduciary—use different measurement focuses and bases of accounting to demonstrate fiscal accountability for governmental funds and operational accountability for proprietary and fiduciary funds.

2.27 Paragraphs 63–112 of GASB Statement No. 34, as amended, provide many of the standards for the fund financial statements. Separate financial statements should be presented for governmental funds, proprietary funds, and fiduciary funds. This section of this chapter describes fund classifications, fund aggregation, and the fund financial statements. Chapters 5–10 discuss the accounting, financial reporting, and auditing considerations in the fund financial statements for specific activities and balances, including interfund activity and balances, which are unique features of governmental financial statements.

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[11] General revenues are all revenues except those required to be reported as program revenues or as contributions, or special or extraordinary items.

Fund Classifications

Update 2-2 *Fiduciary Activities*

GASB Statement No. 84, *Fiduciary Activities*, establishes criteria for identifying and reporting fiduciary activities. The criteria for identification of fiduciary activities primarily focuses on (*a*) whether a government controls the assets of the fiduciary activity and (*b*) the beneficiaries with whom a fiduciary relationship exists.

Governments with activities meeting the criteria will present a statement of fiduciary net position and a statement of changes in fiduciary net position, with certain exceptions.

There are four classifications of fiduciary funds described in GASB Statement No. 84: (1) pension (and other employee benefit) trust funds, (2) investment trust funds, (3) private-purpose trust funds, and (4) custodial funds. Custodial funds should report fiduciary activities that are not held in a trust or equivalent arrangement that meets specific criteria. Note that agency funds will no longer be reported upon application of this statement.

The statement was issued in January 2017 and is effective for fiscal years beginning after December 15, 2018. Earlier application is encouraged.

Upon its effective date, GASB Statement No. 84 will affect the guidance in this chapter.

The full text of the statement is available on GASB's website at www.gasb.org.

2.28 A government's accounting system usually is organized on a fund basis. A fund is a fiscal and accounting entity with a self-balancing set of accounts that the government establishes for accountability purposes in accordance with statutes, laws, regulations, restrictions, or specific purposes. There is no specific number of funds that a government should use. NCGA Statement 1 paragraph 29 states that a government "should establish and maintain those funds required by law and sound financial administration" and that "only the minimum number of funds consistent with legal and operating requirements should be established." Further, NCGA Statement 1 paragraph 30, as amended, indicates that individual funds are not required for financial reporting purposes unless required by legal requirements or by GASB standards, which occasionally require that particular activities be accounted for in a specific fund type. For example, NCGA Statement 1 paragraph 30, as amended, requires the use of a debt service fund if financial resources are being accumulated for future-period debt principal and interest payments.

2.29 Governments should report governmental, proprietary, and fiduciary funds in the fund financial statements to the extent they have activities that meet the criteria in NCGA Statement 1, as amended, and GASB Statement No. 34, as amended, for using those funds. A summary of the resources and activities accounted for and reported in the 11 fund types, by category, follows:

a. Governmental funds

i. *General fund.* All financial resources not accounted for and reported in another fund (a government should report only one general fund).

ii. *Special revenue funds.* The proceeds of specific revenue sources that are restricted or committed to expenditure for specified purposes other than debt service or capital projects. One or more specific restricted or committed revenues should be the foundation for a special revenue fund and also should be expected to continue to comprise a substantial portion of the inflows reported in the fund. Other resources (investment earnings and transfers from other funds, for example) also may be reported in a special revenue fund if those resources are restricted, committed, or assigned to the specified purpose of the fund.

iii. *Capital projects funds.* Financial resources that are restricted, committed, or assigned to expenditure for capital outlay, including the acquisition or construction of capital facilities and other capital assets (other than those financed by proprietary funds or assets that will be held in trust funds for individuals, private organizations, or other governments).

iv. *Debt service funds.* Financial resources that are restricted, committed, or assigned to expenditure for principal and interest. Debt service funds should be used to report resources if legally mandated. Financial resources being accumulated for principal and interest maturing in future years should also be reported in debt service funds.

v. *Permanent funds.* Resources that are restricted to the extent that only earnings, and not principal, may be used for purposes that support the reporting government's programs—that is, for the benefit of the government or its citizenry.

b. Proprietary funds

i. *Enterprise funds.* Permitted or required for any activity for which a fee is charged to external users for goods or services (see paragraph 2.30).

ii. *Internal service funds.* Permitted for any activity that provides goods or services to other funds, departments, or agencies of the primary government and its component units, or to other governments, on a cost-reimbursement basis when the reporting government is the predominant participant in the activity.

c. Fiduciary funds (see also paragraph 2.31)

i. *Pension (and other employee benefit) trust funds.* Resources that are required to be held in trust for the members and beneficiaries of pension plans that are administered through trusts that meet specified criteria, OPEB plans that are administered through trusts that meet specified criteria, or employee benefit plans other than pension or OPEB plans.

ii. *Investment trust funds.* The external portion of external investment pools that the government sponsors.

iii. *Private-purpose trust funds.* All other trust arrangements under which principal and income benefit individuals, private organizations, or other governments.

iv. *Agency funds.* Resources held in a purely custodial capacity for individuals, private organizations, or other governments.

2.30 Enterprise funds may be used to report any activity for which a fee is charged to external users for goods or services. However, GASB Statement No. 34 paragraph 67 states that activities are required to be reported as enterprise funds if any one of the following criteria is met in the context of the activity's principal revenue sources, focusing on fees charged to external users:

a. The activity is financed with debt that is secured solely by a pledge of the net revenues from fees and charges of the activity. (Debt that is secured in part by a portion of its own proceeds should be considered as payable "solely" from the revenues of the activity.)

b. Laws or regulations require that the activity's costs of providing services, including capital costs (such as depreciation or debt service), be recovered with fees and charges, rather than with taxes or similar revenues.

c. The pricing policies of the activity establish fees and charges designed to recover its costs, including capital costs.

Footnote 33 in paragraph 67 of GASB Statement No. 34 states that these criteria do not require insignificant activities of governments to be reported as enterprise funds. Footnote 34 in paragraph 67 of GASB Statement No. 34 and GASB Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, paragraph 18 require that state unemployment compensation funds and public entity risk pools, respectively, always be reported in enterprise funds. (See the further discussion of state unemployment compensation funds and public entity risk pools in chapter 12.)

2.31 A government's fiduciary funds should report only those resources held in a trust or custodial capacity for individuals, private organizations, or other governments. Any resources held for the government itself should not be reported in fiduciary funds, but rather in the fund to which they belong. Further, the trust funds generally are distinguished from agency funds by the existence of a trust agreement, or equivalent arrangement, that affects the degree of management involvement and the length of time that the resources are held.

Fund Aggregation

2.32 A government's governmental and proprietary fund financial statements should present each of its major governmental and enterprise funds (as discussed in paragraph 2.33) in a separate column. Nonmajor governmental and nonmajor enterprise funds should be aggregated and displayed in single columns. The proprietary fund financial statements should aggregate and display all internal service funds in a single column. The fiduciary fund financial statements should aggregate and display fiduciary funds by fund type.

2.33 A government's main operating fund (the general fund or its equivalent) always should be reported as a major fund. Other individual governmental and enterprise funds[12] should be reported as major funds if their total assets and deferred outflows of resources,[13] liabilities and deferred inflows of resources, revenues, or expenses or expenditures (excluding revenues and expenses or expenditures that are extraordinary items) are

a. at least 10 percent of the corresponding total element (total assets and deferred outflows of resources, total liabilities and deferred inflows of resources, and so forth) for all funds of that category or type (that is, the total governmental fund category or the total enterprise fund type) and

b. the same element that met the 10 percent criterion in item *a* is at least 5 percent of the corresponding element total for all governmental and enterprise funds combined.

Further, any other governmental or enterprise fund may be reported as a major fund if the government's officials believe it is particularly important to financial statement users. Appendix B7-3, exercise 5, of the GASB IG 2015-1 includes a nonauthoritative exercise on determining major funds.

Governmental Fund Financial Statements

2.34 Governmental fund financial reporting focuses primarily on the sources, uses, and balances of current financial resources. The financial statements required for governmental funds are the (*a*) balance sheet and (*b*) statement of revenues, expenditures, and changes in fund balances. Those financial statements should be presented using the current financial resources measurement focus and the modified accrual basis of accounting. The governmental funds balance sheet does not report general capital assets or general long-term liabilities. Instead, the statement of revenues, expenditures, and changes in fund balances reports the financial resource inflows and outflows arising from the disposition and acquisition of general capital assets, the issuance and repayment of general long-term debt, and the maturation of nondebt general long-term liabilities, such as compensated absences and claims and judgments.[14] Capital assets and long-term liabilities associated with and generally arising from activities reported in the governmental funds are reported only in the governmental activities column of the government-wide financial statements.

2.35 The governmental funds balance sheet should report information about the current financial resources for each major governmental fund, nonmajor governmental funds in the aggregate, and in total for all governmental funds. This statement should use a balance-sheet format (assets, plus deferred

[12] GASB IG 2015-1 question 7.56.1 explains that the major fund reporting requirements apply to blended component units, which are discussed in chapter 3. Similarly, blended component units are included in the totals of governmental and enterprise funds used to determine major funds.

[13] GASB IG 2015-1 question 7.56.14 explains that interfund receivables and payables are not eliminated when calculating major funds using the 10 percent and 5 percent criteria described in paragraph 2.33*a*–*b*. A government, however, may adopt a policy to "net" significant such receivables and payables consistently within funds.

[14] See the discussion in chapter 8 of GASB Interpretation No. 6, *Recognition and Measurement of Certain Liabilities and Expenditures in Governmental Fund Financial Statements—an interpretation of NCGA Statements 1, 4, and 5; NCGA Interpretation 8; and GASB Statements No. 10, 16, and 18*. Matured nondebt general long-term liabilities are liabilities that normally are due and payable.

outflows of resources equal liabilities, plus deferred inflows of resources, plus fund balances); using a net position format is not an alternative.[15] Fund balances should be segregated into nonspendable, restricted, committed, assigned, or unassigned amounts (see chapter 10). Deferred outflows of resources and deferred inflows of resources pertinent to governmental funds are discussed in paragraph 2.21.

2.36 The governmental funds statement of revenues, expenditures, and changes in fund balances should report information about the inflows, outflows, and balances of current financial resources using the same columnar presentations as does the balance sheet using the following required format, as provided for in GASB Statement No. 34 paragraph 86:

Revenues (detailed)

Expenditures (detailed)

Excess (deficiency) of revenues over expenditures

Other financing sources and uses, including transfers (detailed)

Special and extraordinary items (detailed)

Net change in fund balances

Fund balances—beginning of period

Fund balances—end of period

Proprietary Fund Financial Statements

2.37 Proprietary fund reporting focuses on the determination of operating income, changes in net position (or cost recovery), net position, and cash flows. The financial statements required for proprietary funds are the (*a*) statement of net position, (*b*) statement of revenues, expenses, and changes in fund net position, and (*c*) statement of cash flows. Those financial statements should be presented using the economic resources measurement focus and the accrual basis of accounting.

2.38 The proprietary funds statement of fund net position should report information about the economic resources for each major enterprise fund, all nonmajor enterprise funds in the aggregate, and in total for all enterprise funds. It also should report the combined total for all internal service funds in a separate column to the right of the total enterprise funds column. Governments are encouraged to use a net position format, although a balance sheet format may be used. Net position should be displayed in the three components as required for the government-wide statement of net position (see paragraph 2.17). Assets and liabilities should be presented in a classified format, distinguishing between current and long-term assets and liabilities, as discussed in paragraphs 30–35 of GASB Statement No. 62, as amended. Restricted assets should be reported when restrictions on asset use change the nature or normal understanding of the availability of the asset. Questions 7.22.2 and 7.71.1 of

[15] Because financial statements prepared under the current financial resources measurement focus are excluded from the scope of GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, and GASB Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements*, the recognition of deferred outflows of resources and deferred inflows of resources in those financial statements is limited to the requirements of GASB Statement No. 65.

the GASB IG 2015-1 discuss the reporting of restricted assets using a classified format.

2.39 The statement of revenues, expenses, and changes in fund net position should distinguish between operating and nonoperating revenues and expenses (as discussed in chapter 6) and present a separate subtotal for operating revenues, operating expenses, and operating income. The statement should use the same columnar presentations as does the statement of fund net position using the following required format, as provided for in GASB Statement No. 34 paragraph 101, as amended:

Operating revenues (detailed)

Total operating revenues

Operating expenses (detailed)

Total operating expenses

Operating income (loss)

Nonoperating revenues and expenses (detailed)

Income before other revenues, expenses, gains, losses, and transfers

Capital contributions, additions to permanent and term endowments, special and extraordinary items (detailed), and transfers

Increase (decrease) in net position

Net position—beginning of period

Net position—end of period

2.40 Governments should present a statement of cash flows for proprietary funds based on the provisions of GASB Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*, as amended, using the direct method of presenting cash flows from operating activities (including a reconciliation of operating cash flows to operating income). GASB Statement No. 9, as amended, requires that a statement of cash flows classify cash receipts and payments according to whether they stem from operating, noncapital financing, capital and related financing, or investing activities, and it provides definitions of each category. The statement also requires the reporting of information about all investing, capital, and financing activities during a period that affect recognized assets or liabilities but do not result in cash receipts or cash payments in the period. The GASB IG 2015-1 includes a nonauthoritative exercise that illustrates how governments can indirectly determine amounts of operating cash receipts and payments by adjusting for beginning and ending receivables and payables. Paragraph 6 of the GASB IG 2015-1 provides additional guidance on reporting cash flows.

Fiduciary Fund Financial Statements

2.41 The financial statements required for fiduciary funds are the (*a*) statement of fiduciary net position and (*b*) statement of changes in fiduciary net position. Those financial statements should be presented using the economic resources measurement focus and the accrual basis of accounting. The statement of fiduciary net position should use a net position format (assets, plus deferred outflows of resources, less liabilities, less deferred inflows of resources equal net position); using a balance-sheet format is not an alternative. The statements should provide a separate column for each fund type. GASB IG 2015-1 question 7.77.4 clarifies that each fiduciary component unit should be reported within the appropriate fiduciary fund types, rather than aggregated in a separate fiduciary component units column.

2.42 The statement of fiduciary net position should include information about the assets, deferred outflows of resources, liabilities, deferred inflows of resources, and net position for each fiduciary fund type, but the components of net position, discussed in paragraph 2.17, are not required to be presented in this statement. In the statement of fiduciary net position, agency fund assets should equal liabilities. The statement of changes in fiduciary net position should include information about the additions to, deductions from, and net increase (or decrease) for the year in net position for each trust fund type, providing information about significant year-to-year changes in net position. Agency funds should not be reported in the statement of changes in fiduciary net position.

2.43 Detailed recognition and presentation requirements for defined benefit pension plans administered through trusts or equivalent arrangements that meet specified criteria, and certain OPEB plans administered through trusts or equivalent arrangements that meet specified criteria, are discussed in chapter 13, "Defined Benefit Pension Plans (Plan & Employer Considerations)," and chapter 14 of this guide, respectively, and in GASB IG 2015-1 paragraph 14. Investment trust funds are discussed in chapter 12.

Financial Statement Reconciliations

2.44 Governments should present summary reconciliations to the government-wide financial statements on the governmental and proprietary (enterprise) fund financial statements or in accompanying schedules. Those reconciliations will help financial statement users understand how the fund financial statements relate to the government-wide financial statements. See the further discussion of the financial reporting and auditing considerations for those financial statement reconciliations in chapter 10.

Notes to the Financial Statements

2.45 The notes to the financial statements should communicate information essential for the fair presentation of the basic financial statements that is not displayed on the face of the financial statements. As such, the notes are an integral part of the basic financial statements. GASB standards require specific disclosures for various types of activities and balances that are unique to or significant in government. Certain information may be presented either on the face of the financial statements or in the notes to the financial statements.

2.46 The notes to the financial statements should focus on the primary government—specifically, its governmental activities, business-type activities, major funds, and nonmajor funds in the aggregate. Information about the government's discretely presented component units may need to be presented in the notes, as discussed in chapter 3.

2.47 The principal guidance for note disclosures is contained in NCGA Interpretation 6, *Notes to the Financial Statements Disclosure*, as amended, and GASB Statement No. 62, as amended, as well as various other NCGA and GASB pronouncements. Many of the chapters in this guide discuss note disclosures required for governmental financial statements. The following are among the significant required disclosures that are not discussed elsewhere in this guide:

- A description of the government-wide financial statements, noting that fiduciary funds are not included
- The measurement focus and basis of accounting used in the government-wide statements
- For governments that present their primary government in more than a single column, a description of the activities accounted for in each major fund, the internal service funds, and the fiduciary fund types (for other than the general fund or its equivalent, the descriptions should be specific to the government, rather than general definitions that could describe any government)
- Material violations of finance-related legal and contractual provisions and the actions taken to address such violations
- Tax abatement information as required by GASB Statement No. 77, *Tax Abatement Disclosures*, for the reporting government including brief descriptive information, the gross dollar amount of taxes abated during the period, and other commitments made by a government as part of a tax abatement agreement; for tax abatements entered into by other governments that affect a reporting government's tax revenues disclosures including the names of the governments that entered into the agreements, the specific taxes being abated, and the gross dollar amount of taxes abated during the period.

2.48 The notes to the financial statements should include a summary of significant accounting policies, as required by NCGA Statement 1 and paragraphs 90–95 of GASB Statement No. 62. As provided for in paragraph 93 of GASB Statement No. 62, the summary of significant accounting policies should encompass those accounting principles and methods that involve any of the following:

- A selection from existing acceptable alternatives
- Principles and methods peculiar to the industry in which the government (for example, a special-purpose district) operates, even if such principles and methods are predominantly followed in that industry
- Unusual or innovative applications of GAAP (and, as applicable, of principles and methods peculiar to the industry in which the government operates)

NCGA Interpretation 6 paragraph 6, as amended by GASB Statement No. 34, states that although a summary of significant accounting policies is a required disclosure, it may be a stand-alone summary or may be included as the initial note to the financial statements. If it is a stand-alone summary, each page of the basic financial statements should be referenced thereto and also to the notes to financial statements.

Required Supplementary Information Other Than MD&A

2.49 GAAP requires the presentation of certain RSI. RSI differs from other types of information that accompanies the basic financial statements because

RSI is considered an essential part of financial reporting and has established authoritative guidelines for measuring and presenting that information. GASB Concepts Statement No. 3 indicates that RSI is supporting information that GASB has concluded is essential for placing basic financial statements and notes to the basic financial statements in an appropriate operational, economic, or historical context. Further, RSI should have a clear and demonstrable relationship to information in the basic financial statements or notes to the basic financial statements to which it pertains.

2.50 GASB Statement No. 34, as amended, requires budgetary comparisons to be presented for the general fund and for each major special revenue fund that has a legally adopted annual budget. As discussed in paragraph 2.97, governments are encouraged by GASB to present such budgetary comparison information as a part of RSI, rather than as a basic financial statement, because that information is not considered essential to the users' understanding of the financial position and results of operations of a government. However, as provided in GASB Statement No. 41, *Budgetary Comparison Schedules—Perspective Differences—an amendment of GASB Statement No. 34*, a government with significant budgetary perspective differences that result in the government's not being able to present budgetary comparisons for the general fund and each major special revenue fund should present budgetary comparison schedules as RSI based on the fund, organization, or program structure that they use for their legally adopted budget. GASB Statement No. 34, as amended, allows governments, except those subject to GASB Statement No. 41, to elect to report the required budgetary comparison information in a budgetary comparison statement as part of the basic financial statements, rather than as RSI. The budgetary comparison information should present both (*a*) the original and (*b*) the final appropriated budgets for the reporting period as well as (*c*) actual inflows, outflows, and balances, stated on the government's budgetary basis. This information will demonstrate whether resources were obtained and used in accordance with the entity's legally adopted budget. See the further discussion of the financial reporting and auditing considerations for budgetary comparison information in chapter 11, "The Budget."

2.51 The following GASB standards include provisions for RSI other than MD&A (discussed in paragraphs 2.09–.10) and budgetary comparison information (discussed in paragraph 2.50):

- GASB Statement No. 10, as amended by GASB Statement No. 30, *Risk Financing Omnibus—an amendment of GASB Statement No. 10*, requires public entity risk pools to include certain revenue and claims development information. (See chapter 12.)
- GASB Statement No. 34, as amended, requires schedules of assessed condition and estimated and actual maintenance and preservation costs for governments that use the modified approach for infrastructure assets. (See chapter 7.)
- GASB Statement No. 67, *Financial Reporting for Pension Plans—an amendment of GASB Statement No. 25*, as amended, requires single-employer and cost-sharing pension plans that are administered through trusts or equivalent arrangements that meet certain criteria to present in RSI various information about (*a*) sources of changes in the net pension liability, (*b*) information

about the components of the net pension liability and related ratios, and (*c*) if an actuarially determined contribution is calculated for employers or nonemployer contributing entities, a schedule covering each of the 10 most recent fiscal years that includes information about the actuarially determined contribution, contributions to the pension plan, and related ratios. All defined benefit pension plans subject to Statement No. 67 should present a 10-year schedule presenting for each fiscal year the annual money-weighted rate of return on pension plan investments. (See chapter 13.)

- GASB Statement No. 68, as amended, requires single and agent employers providing pension benefits administered through trusts or equivalent arrangements that meet the criteria in the statement to present in RSI certain 10-year schedules as discussed in paragraph 46 of GASB Statement No. 68, as amended, including information on the changes in the employer's net pension liability, components of the net pension liability and key ratios, and information on actuarial, statutory or contractual contributions. The statement requires cost-sharing employers that are not within the scope of GASB Statement No. 78, *Pensions Provided Through Certain Multiple-Employer Defined Benefit Pension Plans*, to present in RSI certain 10-year schedules as discussed in paragraph 81 of GASB Statement No. 68, as amended, including information on the employer's proportionate share (amount) of the collective net pension liability and information on statutorily or contractually required contributions. The statement requires additional RSI when there are nonemployer contributing entities in special funding situations. (See chapter 13.)
- GASB Statement No. 73 requires employers that are not within the scope of GASB Statement No. 68 or GASB Statement No. 78 to present in RSI certain 10-year schedules as discussed in paragraph 45 of GASB Statement No. 73, including information on the changes in the total pension liability and key ratios. The statement requires governments and component units that provide pensions through the same defined benefit pension plan to present in RSI a 10-year schedule as discussed in paragraph 66 of GASB Statement No. 73, including the government's proportion (percentage) and proportionate share (amount) of the collective total pension liability and key ratios. The statement requires additional RSI when governments or components units are in special funding situations. (See chapter 13.)
- GASB Statement No. 74, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, requires single-employer and cost-sharing OPEB plans to present as RSI certain 10-year schedules as discussed in paragraph 36 of GASB Statement No. 74, including (*a*) sources of the changes in the net OPEB liability; (*b*) information about the components of the net OPEB liability and related ratios; and (*c*) if an actuarially determined contribution is calculated for employers or nonemployer contributing entities, a schedule covering each of the 10 most recent fiscal years that includes information about the actuarially determined contribution, contributions to the OPEB plan, and related

ratios. The statement requires all OPEB plans that are administered through trusts that meet specified criteria to present as RSI a 10-year schedule presenting for each fiscal year the annual money-weighted rate of return on OPEB plan investments, calculated as required by paragraph 34 of GASB Statement No. 74. (See chapter 14.)

Update 2-3 *Required Supplementary Information Other Than MD&A*

GASB Statement No. 75 requires single and agent employers to present in RSI, for the 10 most recent fiscal years, sources of changes in the net OPEB liability and the components of the net OPEB liability and related ratios, including the plan's fiduciary net position as a percentage of the total OPEB liability, and the net OPEB liability as a percentage of covered-employee payroll. Employers who provide OPEB through an OPEB plan that is not administered through a trust or equivalent arrangement that meet the specified criteria are required to present a note to the schedules disclosing that no assets are accumulated in a trust that meets the specified criteria, as well as information about the factors that significantly affect trends in the amounts reported. Upon its effective date, the statement will supersede the provisions of GASB Statement No. 45 and GASB Statement No. 57.

The statement was issued in June 2015 and is effective for fiscal years beginning after June 15, 2017. Earlier application is encouraged.

Those implementing GASB Statement No. 75 may refer to chapter 14 for guidance related to accounting and reporting for OPEB. The full text of the statement is available on GASB's website at www.gasb.org.

GAAP requirements for certain RSI also provide for certain notes to the RSI. As discussed in chapter 16, "Audit Reporting," those notes are part of the prescribed guidelines. Further, presenting RSI for discretely presented component units is a matter of professional judgment, as discussed in chapter 3.

2.52 GASB Statement No. 34 paragraph 6 and footnote 5 require that RSI other than MD&A be presented immediately following the notes to the financial statements, except for the revenue and claims development information presented by certain public entity risk pools, as discussed in the public entity risk pools section of chapter 12.

Special-Purpose Governments

2.53 *Special-purpose governments* are legally separate entities that perform only one activity or only a few activities, such as cemetery districts, school districts, colleges and universities, utilities, hospitals and other health care organizations, port authorities, transit agencies, airports, public housing authorities, financing authorities, and public employee retirement systems. GASB Statement No. 34, as amended, provides that certain special-purpose governments should present different basic financial statements from those previously described. The required financial statements for those entities are designed to be appropriate to the nature and mix of the activities they perform. See the further discussion of the financial reporting and auditing considerations for special-purpose governments in chapter 12.

Other Financial Reporting Issues

Other Information and Supplementary Information

2.54 "GASB defined" SI may be either OI as defined in AU-C section 720 or SI as defined in AU-C section 725. Although "GASB defined" SI is not required to accompany the basic financial statements, many governments present this information with their basic financial statements. GASB standards exist for certain "GASB defined" SI, such as the combining and individual fund financial statements, and certain statistical information that should be presented in a Comprehensive Annual Financial Report (CAFR). A CAFR comprises the basic financial statements and RSI and is accompanied by certain "GASB defined" SI. From an auditing perspective, the "GASB defined" SI will be considered SI if (*a*) the required conditions in AU-C section 725 have been met and (*b*) the auditor has been engaged to provide an "in relation to" opinion. Otherwise, the information will be considered OI for situations when the limited procedures in AU-C section 720 are required.

NCGA Statement 1 paragraph 139, as amended, contains the requirements for the contents of a CAFR. A CAFR includes the following "GASB defined" SI:

a. *Introductory section*—This section includes a table of contents, letter(s) of transmittal, and other material deemed appropriate by management. In practice, this information is typically considered OI (that is, auditors are not typically engaged to provide an "in relation to" opinion on the introductory section).

b. *Appropriate combining and individual fund financial statements and schedules*—This section has the following:

   i. Combining statements, which should present (*a*) the nonmajor governmental and enterprise funds, internal service funds, and fiduciary funds of the primary government (including its blended component units)—all by fund type,[16] (*b*) the nonmajor discretely presented component units, and (*c*) the fund financial statements of individual component units if the information is not available in separately issued financial statements of the individual component units.

   ii. Individual fund statements, which should be presented when the primary government has only one nonmajor fund of a given fund type (unless presented in the combining statements) or if they are needed to present prior-year and budgetary comparisons that are not presented in RSI.

   iii. Schedules, which should be used to (*a*) demonstrate compliance with finance-related legal and contractual provisions, (*b*) present information spread throughout the statements that can be brought together and shown in greater detail, and (*c*) present greater detail for information reported in the statements.

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[16] The Comprehensive Annual Financial Report also should present a combining statement of changes in assets and liabilities for all agency funds.

In practice, this information is typically considered SI (that is, auditors are often engaged to provide an "in relation to" opinion on the combining statements, individual fund financial statements, and schedules).

c. *Statistical section*—GASB Statement No. 44, *Economic Condition Reporting: The Statistical Section—an amendment of NCGA Statement 1*, as amended, requires a statistical section to present detailed information, typically in ten-year trends, in five categories: financial trends information, revenue capacity information, debt capacity information, demographic and economic information, and operating information. (GASB IG 2015-1 paragraph 15 answers various questions about Statement No. 44. Appendix B9-2 to that chapter provides nonauthoritative illustrations of the provisions of Statement No. 44 for various example types of governments.) In practice, this information is typically considered OI (that is, auditors are not typically engaged to provide an "in relation to" opinion on the statistical section).

The three sections previously listed are required parts of a CAFR in addition to the basic financial statements, but governments are not required to prepare those sections if they do not present their basic financial statements within a CAFR. OI and SI that are "required" to accompany a CAFR remain OI and SI; that is, they do not become RSI when presented as part of a CAFR (see paragraph 4.127 of this guide). Paragraphs 2.93–.94 discuss auditing considerations for RSI, OI, and SI.

Prior-Period Comparative Financial Information

2.55 Governments sometimes present partial or summarized (or partial and summarized) prior-period comparative financial information in their basic financial statements rather than making a complete prior-period presentation at the level of detail required by GAAP. For example, a government may present prior-year financial information only for its government-wide financial statements and not also for its fund financial statements. As another example, a government may present prior-year financial information in its government-wide financial statements only for the total reporting entity rather than disaggregated by governmental activities, business-type activities, total primary government, and discretely presented component units.

2.56 If prior-period financial information is presented in a partial or summarized manner and does not include the minimum information required by GAAP, the nature of the prior-period information should be described by the use of appropriate titles on the face of the financial statements and in a note to the financial statements. Such labeling and disclosure is supported by the provisions of paragraph 53 of GASB Statement No. 62, which states "it is necessary that prior-period figures shown for comparative purposes be, in fact, comparable with those shown for the most recent period, or that any exceptions to comparability be clearly brought out as described in paragraphs 63–89 of GASB Statement No. 62." The use of appropriate titles includes a phrase such as "with [*partial/summarized*] financial information for the year ended June 30, 20PY," as part of the title of the statement or, instead, column headings that indicate the partial or summarized nature of the information. Labeling the prior-period partial or summarized financial information "for comparative purposes only" without further disclosure in the notes to the financial statements would not constitute the use of an appropriate title. An example of a note to the financial statements[17] that describes the summarized nature of prior-period information would be as follows:

> The basic financial statements include certain prior-year summarized comparative information in total but not at the level of detail required for a presentation in accordance with generally accepted accounting principles. Accordingly, such information should be read in conjunction with the government's financial statements for the year ended June 30, 20PY, from which the summarized information was derived.

Chapter 16 discusses auditors' reports on prior-period financial information.

Government Combinations and Disposals of Government Operations

2.57 GASB Statement No. 69 establishes accounting and financial reporting standards related to government combinations and disposals of government operations and uses the term government combinations to include a variety of transactions referred to as mergers, acquisitions, and transfers of operations.

2.58 According to GASB Statement No. 69, the distinction between a government merger and a government acquisition is based upon whether an exchange of significant consideration is present within the combination transaction. Government mergers include combinations of legally separate entities without exchange of significant consideration. Conversely, government acquisitions are transactions in which a government acquires another entity, or its operations, in exchange for significant consideration. The statement also provides guidance for transfers of operations that do not constitute legally separate entities and in which no significant consideration is exchanged and for disposals of government operations that have been transferred or sold. The statement also provides guidance for transfers of operations that do not constitute legally separate entities and in which no significant consideration is exchanged and for disposals of government operations that have been transferred or sold.

2.59 Audit reporting considerations related to changes in the financial reporting entity are discussed in chapter 3.

Fair Value Measurement

2.60 GASB Statement No. 72, *Fair Value Measurement and Application*, addresses accounting and financial reporting issues related to fair value measurements. It defines fair value, establishes a framework for measuring fair value, provides guidance for applying fair value to certain investments, and requires disclosures related to all fair value measurements. The following paragraphs summarize measurement principles from GASB Statement No. 72 but are not a substitute for reading the statement itself.

General Principles of Fair Value

2.61 Paragraph 5 of GASB Statement No. 72 defines *fair value* as the price that would be received to sell an asset or paid to transfer a liability (exit price) in an orderly transaction between market participants at the measurement

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[17] Because the note discusses information that does not pertain to the current-period financial statements, the note is not considered to be part of the current-period financial statements.

date. Fair value is a market-based measurement, not an entity-specific measurement. The objective of fair value measurement is to determine the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participant at the measurement date under current market conditions.

2.62 Paragraph 14 of GASB Statement No. 72 states that even if there are no observable market transactions to provide pricing information about the sale of an asset or the transfer of a liability at the measurement date, a fair value measurement should assume that a transaction takes place at that date, considered from the perspective of a market participant that controls the asset or is obligated for the liability. That assumed transaction establishes a basis for determining the price to sell the asset or to transfer the liability.

2.63 The focus of a fair value measurement is on a particular asset or liability. When measuring an asset or liability at fair value, a government should consider the same characteristics of the asset or liability that market participants would consider when pricing the asset or liability at the measurement date. For example, a market participant may consider the location and condition of an asset, or restrictions on its use, in pricing the asset at the measurement date.

2.64 As discussed in paragraph 8 of GASB Statement No. 72, measurement, recognition, or disclosure of an asset or liability—whether a single asset or a liability or a group—depends on the unit of account of the asset or liability. Once the unit of account is established, relevant measurement attributes and disclosures can be applied.

2.65 In accordance with paragraph 9 of GASB Statement No. 72, fair value measurement assumes that a transaction to sell an asset or transfer a liability takes place in either (*a*) a government's *principal market* or (*b*) a government's *most advantageous market* in the absence of a principal market. The principal market is the market with the greatest volume and level of activity for an asset or liability. The most advantageous market is the market that maximizes the amount that would be received to sell an asset or minimizes the amount that would be paid to transfer a liability, after taking into account transaction costs and transportation costs. Paragraphs 10–14 of GASB Statement No. 72 provide more detail on identification of markets.

Emphasis Point

In the absence of evidence to the contrary, the market in which the government normally sells the asset or transfers the liability is presumed to be the principal or the most advantageous market. Determination of the principal or most advantageous market is considered from the government's perspective; thus, different governments may have different principal markets for identical assets or liabilities.

Price and Transaction Costs

2.66 In accordance with paragraph 16 of GASB Statement No. 72, the price in the principal or the most advantageous market used to measure the fair value of an asset or a liability should not be adjusted for transaction costs, even if those costs are separable. Such costs are not a characteristic of an asset or a liability for fair value measurement. Rather, they are specific to a transaction and will differ depending on how a government enters into a transaction for the asset or liability. Further, paragraph 17 of GASB Statement No. 72 clarifies that transaction costs do not include transportation. However, transportation costs should be included in the fair value price of an asset in the principal or most advantageous market if location is a characteristic of the asset (as might be the case for a commodity).

Fair Value of Nonfinancial Assets

2.67 Paragraphs 55–58 of GASB Statement No. 72 provide guidance for the fair value measurement of nonfinancial assets. A fair value measurement of a nonfinancial asset takes into account a market participant's ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant that would use the asset in its highest and best use, considering the use of the asset that is physically possible, legally permissible, and financially feasible at the measurement date. A government may not intend to use the nonfinancial asset according to its highest and best use; nevertheless, the government should measure the fair value of a nonfinancial asset assuming its highest and best use by market participants.

Fair Value of Liabilities

2.68 Paragraphs 59–63 of GASB Statement No. 72 provide guidance for the fair value measurement of liabilities. Measurement of the fair value of a liability (for example, an interest rate swap that is in a liability position to a government) assumes that the liability is transferred to a market participant at the measurement date. The fair value of a liability reflects the effect of nonperformance risk (the risk that an entity will not fulfill an obligation). Nonperformance risk is assumed to be the same before and after the transfer of the liability. Because nonperformance risk includes (but may not be limited to) a reporting entity's own credit risk, a government should take into account the effect of its credit standing and any other factors that might influence the likelihood that the obligation will or will not be fulfilled when measuring the fair value of a liability.

Valuation Techniques

2.69 To measure fair value, paragraph 18 of GASB Statement No. 72 requires a government to use valuation techniques that are appropriate in the circumstances and for which sufficient data are available, maximizing the use of observable inputs and minimizing the use of unobservable inputs. A government should use valuation techniques consistent with one or more of the three approaches to measuring fair value as described in paragraphs 23–27 of GASB Statement No. 72:

- The *market approach* uses prices and other relevant information generated by market transactions involving identical or similar assets, liabilities, or groups of assets and liabilities. Techniques that are consistent with the market approach include the use of quoted market prices, the use of the market multiples technique and the matrix pricing technique.
- The *income approach* converts future amounts (for example, cash flows or revenues and expenses) to a single current (that is, discounted) amount. When the income approach is used, the fair value measurement reflects current market expectations about future amounts. Valuation techniques that are consistent with the

income approach include present value techniques, option pricing models, and multiperiod excess earnings methods.

- The *cost approach* reflects the amount that would be required currently to replace the present service capacity of an asset (often referred to as current replacement cost). Fair value is determined based on the cost to a market participant (buyer) to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence.

2.70 Paragraph 19 of GASB Statement No. 72 addresses when a single valuation technique is appropriate versus when multiple valuation techniques may be used. If multiple valuation techniques are used to measure fair value, the results should be evaluated considering the reasonableness of the range of values indicated by those results. A fair value measurement is the point within that range that is most representative of fair value in the circumstances.

2.71 In accordance with GASB Statement No. 72, valuation techniques should be applied consistently from period to period. However, a change in a valuation technique or its application is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances. Such a change would be accounted for a change in accounting estimate in accordance with paragraph 22 of GASB Statement No. 72.

Inputs to Valuation Techniques

2.72 In accordance with paragraph 28 of GASB Statement No. 72, valuation techniques should maximize the use of relevant observable inputs and minimize the use of unobservable inputs. Paragraph 28 of GASB Statement No. 72 states that if there is a quoted price in an active market for an identical asset or liability, a government should use that quoted price without adjustment if measuring fair value. However, there are exceptions as discussed in paragraph 38 of GASB Statement No. 72 for circumstances in which there are a large number of similar assets or liabilities, quoted price not representative of fair value, or fair value of an asset not representative of fair value of a liability.

2.73 Paragraph 29 of GASB Statement No. 72 requires the selection of inputs that are consistent with the characteristics of the asset or liability that market participants would consider in a transaction for the asset or liability. Some of these characteristics will result in a fair value measurement with the application of an adjustment (for example, a control premium or noncontrolling interest discount). However, a premium or discount should not be considered in a fair value measurement if inconsistent with the unit of account.

2.74 In accordance with paragraph 30 of GASB Statement No. 72, a premium or discount with size as a characteristic of a government's holding are not permitted in the measurement of fair value (for example, a blockage factor, that when applied to a level 1 input would adjust the quoted price of an asset or liability because the market's normal daily trading volume is not sufficient to absorb the quantity held by a government).

2.75 Further, if an asset or liability measured at fair value has a bid price and an ask price, the price within the bid-ask spread that is most representative of fair value under the circumstances should be used as discussed in paragraph 31 of GASB Statement No. 72. If no price is more representative than another, the use of a bid price (for an asset position) and an ask price (for a liability position) is permitted.

Fair Value Hierarchy

2.76 GASB Statement No. 72 emphasizes that fair value is a market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement should be determined based on the assumption market participants would use in pricing the asset or liability (referred to as inputs). Paragraphs 32–44 of GASB Statement No. 72 establish a fair value hierarchy that distinguishes between (1) inputs that are developed using market data—such as publicly available information about actual events or transactions—that reflect the assumptions market participants would use when pricing the asset or liability (observable inputs) and (2) inputs for which market data are not available and that are developed using the best information available about the assumptions market participants would use when pricing the asset or liability (unobservable inputs). Valuation techniques used to measure fair value should maximize the use of observable inputs and minimize the use of unobservable inputs. Although the selection of valuation techniques might be affected by the availability and subjectivity of the inputs selected, the fair value hierarchy does not prioritize valuation techniques.

2.77 The fair value hierarchy in GASB Statement No. 72 characterizes into three levels the inputs to valuation techniques used to measure fair value. The three levels, described in paragraphs 36–44 of GASB Statement No. 72, are as follows:

- Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that a government can access at the measurement date. An active market is a market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis. A quoted price in an active market provides the most reliable evidence of fair value and should be used without adjustment to measure fair value whenever available, except as discussed in paragraph 38 of GASB Statement No. 72.

- Level 2 inputs are inputs other than quoted prices included within level 1 that are observable for an asset or liability, either directly or indirectly. If the asset or liability has a specified (contractual) term, a level 2 input must be observable for most of the full term of the asset or liability. Adjustments to level 2 inputs will vary depending on factors specific to the asset or liability. An adjustment to a level 2 input that is significant to the entire measurement might result in a fair value measurement categorized within level 3 of the fair value hierarchy if the adjustment uses significant unobservable inputs. Level 2 inputs include the following:

    — Quoted prices for similar assets or liabilities in active markets

    — Quoted prices for identical or similar assets or liabilities in markets that are not active

    — Inputs other than quoted prices that are observable for the asset or liability (for example interest rates and yield curves observable at commonly quoted intervals, implied volatilities, and credit spreads)

  - Inputs that are derived principally from or corroborated by observable market data by correlation or other means (market-corroborated inputs)

- Level 3 inputs are unobservable inputs for an asset or liability. Unobservable inputs should be used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. In developing unobservable inputs, the reporting entity need not undertake exhaustive efforts to obtain information about market participant assumptions. However, a reporting entity should take into account all information about market participant assumptions that is reasonably available. Unobservable inputs are developed using the best information available about the assumptions that market participants would use when pricing the asset or liability.

2.78 In some cases, the inputs used to measure the fair value of an asset or a liability might be categorized within different levels of the fair value hierarchy. In those cases, paragraph 33 of GASB Statement No. 72 states that the measurement is considered to be based on the lowest priority level input that is significant to the entire measurement. Assessing the significance of a particular input to the entire measurement requires professional judgment.

2.79 As discussed in paragraph 34 of GASB Statement No. 72, the availability of relevant inputs and their relative subjectivity might affect the selection of appropriate valuation techniques. However, the fair value hierarchy prioritizes the inputs to valuation techniques, not the valuation techniques used to measure fair value. For example, a fair value measurement developed using a present value technique might be categorized within level 2 or level 3, depending on the inputs that are significant to the entire measurement and the level of the fair value hierarchy within which those inputs are categorized.

Guidance for Fair Value Measurement in Special Circumstances

2.80 GASB Statement No. 72 provides additional guidance for fair value measurement in the following circumstances:

- Measuring fair value if the volume or level of market activity for an asset or a liability has significantly decreased (paragraphs 45–48)
- Identifying transactions that are not orderly (paragraphs 49–51)
- Using quoted prices provided by third parties (paragraphs 52–54)
- Measuring fair value of liabilities held by other parties as assets (paragraphs 60–61)
- Measuring the fair value of investments in certain entities that calculate net asset value per share or its equivalent (paragraphs 71–74)

Measuring Fair Value in a Significantly Decreased Market

2.81 If there has been a significant decrease in the volume or level of activity for the asset or liability in relation to normal market activity for the asset or liability (or similar assets or liabilities), further analysis of the transactions or quoted prices is needed. A decrease in the volume or level of activity on its own may not indicate that a transaction price or quoted price does not represent fair value. However, if a government determines that a transaction or quoted price does not represent fair value (for example, there may be transactions that are not orderly), an adjustment will be necessary if the government uses those transactions or prices as a basis for measuring fair value and the adjustment is significant to the fair value measurement in its entirety. Adjustments also may be necessary in other circumstances (for example, when a price for a similar asset requires significant adjustment to make it comparable to the asset being measured or when the price is stale). Further, if there has been a significant decrease in the volume or level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate (for example, changing from a technique based on market-observed prices to an expected cash flow technique).

Identifying Transactions That Are Not Orderly

2.82 When measuring fair value, a government should take into account transaction prices for orderly transactions. If evidence indicates that a transaction is not orderly, a government should place little, if any, weight (compared with other indications of fair value) on that transaction price. When a government does not have sufficient information to conclude whether particular transactions are orderly, it should place less weight on those transactions when compared with other transactions that are known to be orderly.

2.83 To determine whether a transaction is orderly, a government should consider information that is reasonably available. If the government is a party to a transaction, the government is presumed to have sufficient information to determine whether the transaction is orderly.

Using Quoted Prices Provided by Third Parties

2.84 A government may use quoted prices provided by third parties, such as pricing services or brokers, if it has determined that those prices are developed in accordance with GASB Statement No. 72. More weight should be given to quotes provided by third parties that represent binding offers than to quotes that are indicative prices. Less weight (when compared with other indications of fair value that reflect the results of transactions) should be placed on quotes that do not reflect the result of transactions.

Investments in Entities That Calculate Net Asset Value Per Share

2.85 If an investment in a nongovernmental entity does not have a readily determinable fair value, a government is permitted, as a practical expedient, to estimate the fair value of the investment using its net asset value per share (or its equivalent, such as member units or an ownership interest in partners' capital to which a proportionate share of net assets is attributed), if the criteria in paragraphs 71–74 of GASB Statement No. 72 are met. Chapter 5, "Financial Instruments," provides additional information about the circumstances in which this practical expedient is permitted.

Auditing Considerations

2.86 A significant consideration in auditing a government's financial statements is to understand the unique requirements for financial statement presentation. Auditors should understand GAAP for financial statement presentation as discussed in this and other chapters of this guide, as well as the engagement's reporting objective as discussed in chapter 4, "General Auditing Considerations." Chapter 16 discusses the effect on the auditor's opinions in various situations when a government's basic financial statements are not presented in accordance with GAAP.

Compliance Requirements

2.87 As discussed in chapter 4, the auditor should determine that a government's financial statements appropriately consider compliance requirements that have a direct and material effect on the determination of financial statement amounts. An example would be evaluating whether separate funds are maintained and reported when required by legal or contractual provisions, such as those arising from the entity's own constitutional or legislative provisions and from grants, contributions, and appropriations received from other governments and from nongovernmental entities. Legal and contractual provisions may sometimes use the terminology *separate funds* or *separate accounts*, when the intention of those provisions is a separate accounting for restricted resources, which does not necessarily require the government to establish separate funds or bank accounts for the resources. An example of a situation that may require evaluation of whether a separate accounting is intended is a debt agreement (covenant or indenture) that specifies that the entity maintain separate depreciation, bond reserve, and debt service "funds." Conversely, legal and contractual provisions may require a segregation of resources for a particular purpose but not use the terminology *separate funds*. In either case, the intent of the debt agreement should be determined. The auditor may need to consult legal counsel to evaluate whether legal or contractual provisions require the use of separate funds for financial reporting purposes. As noted in paragraph 2.28, there is no specific number of funds that a government should use.

Fund and Activity Classifications

2.88 One consideration in the audit of a government's financial statements is whether the government has properly segregated activities into funds and reported its funds in the proper fund classifications. Those classifications depend not only on compliance requirements, as discussed in paragraph 2.87, but also on the GAAP definitions of the various funds, as discussed in paragraphs 2.28–.31. Another consideration is whether a government's activities are properly classified as governmental or business-type in the government-wide financial statements. Those classifications depend on the GAAP definitions relating to those classifications as well as the government's fund classification of the underlying fund activity, as discussed in paragraph 2.12 and footnotes 5–6.

Major Funds

2.89 The auditor should evaluate the government's quantitative determination of major funds to determine whether all required major funds are separately displayed in the fund financial statements. Chapter 16 discusses the effect on the auditor's report if quantitatively determined major funds are not separately displayed. GASB Statement No. 34, as amended, permits (but does not require) governments to report as a major fund any governmental or enterprise fund other than those that meet the quantitative criteria if the government's officials believe it is particularly important to financial statement users. That permitted presentation of major funds based on management judgment gives management broad discretion in designating additional funds as major, and the auditor is not required to evaluate management's judgment in that regard. However, the auditor should consider obtaining a written representation from current management indicating that management believes that all judgmentally determined major funds are particularly important to financial statement users. The standards for selecting major funds could result in different funds being reported as major each year. As discussed in chapter 16, such changes should not be considered a change in accounting principles affecting consistency.[18] Chapter 10 discusses audit procedures for the opening fund balance (or net position) of major funds that were not audited as major the previous year.

Restricted Assets

2.90 Assets are reported in the financial statements[19] as restricted when the nature and amount of those assets satisfy the applicable legal and contractual provisions. The auditor should evaluate the adequacy of the government's compliance with restrictions and its financial reporting of those restrictions, and consider the effect on the auditor's report on the financial statements. For example, the auditor may find that assets restricted for debt retirement include amounts due from other funds. In that situation, there is an implication that the underlying assets have not been appropriately restricted from general use and, thus, noncompliance with the requirement for restriction of the assets.

Notes to the Financial Statements

2.91 As stated earlier in this chapter, the notes to the financial statements should communicate information essential for fair presentation of the basic financial statements that is not displayed on the face of the financial statements. In addition to that basic rule, certain notes to the financial statements are specifically required for the basic financial statements to be in accordance with GAAP. Chapter 4 discusses the auditor's responsibility concerning whether the government makes required disclosures in accordance with GAAP. The auditor should evaluate whether the government's basic financial statements properly present all material note disclosures and the effect on the auditor's report on the financial statements if material disclosures are omitted or not presented in accordance with GAAP, as further discussed in chapter 13.

2.92 Like the provisions of all GASB standards, notes to the financial statements are not required for immaterial items. In fact, NCGA Interpretation 6 paragraph 6 states that "The notes to financial statements should not be cluttered with unnecessary and immaterial disclosures. Attendant circumstances and materiality must be considered in assessing the propriety of the notes to the financial statements disclosures." If the auditor determines that the government's notes to the financial statements present unnecessary and

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[18] Management may, in the interest of interperiod consistency, choose to report a governmental or enterprise fund as a major fund even though it does not meet the quantitative criteria.

[19] GASB IG 2015-1 question 7.22.2 states "Statement 34 does not require separate presentation of restricted assets in the government-wide statement of net position for either governmental activities or business–type activities; however, the decision to use the classified format may result in the presentation of a portion of restricted assets as 'noncurrent'." Note, however, that GASB Statement No. 34 paragraph 99, as amended, requires, for proprietary funds, that restricted assets should be reported when restrictions on asset use change the nature or normal understanding of the availability of the asset.

immaterial disclosures, the auditor may advise the government of such disclosures. However, the presentation of unnecessary and immaterial disclosures does not affect the auditor's report on the financial statements because the presentation does not cause material misstatements of the financial statements.

Required Supplementary Information, Supplementary Information, and Other Information

2.93 Chapter 4 discusses the procedures that an auditor applies to RSI, SI, and OI as defined in AU-C section 730, AU-C section 725, and AU-C section 720, respectively and chapter 16 discusses the auditor's reporting responsibilities for RSI, SI, and OI. As noted earlier in this chapter, GASB standards require MD&A to precede the basic financial statements and most other RSI (such as budgetary comparison information, information related to pension and OPEB, and information on assessed condition and estimated and actual maintenance and preservation costs for governments that use the modified approach for infrastructure assets) to be presented immediately following the notes to the financial statements. If the measurement or presentation of the RSI departs materially from the prescribed guidelines, the auditor should include a statement that although the auditor's opinion on the basic financial statements is not affected, material departures exist. The auditor should then describe the departures in an emphasis-of-matter paragraph. If some or all of the RSI is omitted, additional statements by the auditor should be included. Chapter 16 further describes the auditor's reporting required by AU-C section 730 for both of these situations. (As discussed in chapter 16, the manner in which RSI is presented does not affect the auditor's *opinions* on the opinion units presented in the basic financial statements.)

2.94 Only information required by GAAP to be presented as RSI can be considered RSI. As part of the auditor's procedures for RSI, the auditor should consider whether MD&A and other RSI includes information that is not required by GAAP. For example, information presented in MD&A should be confined to the topics discussed in GASB Statement No. 34 paragraph 11, as amended (as discussed in paragraph 2.09). If the government presents additional information as part of RSI, the auditor should consider whether to report that the RSI content constitutes a presentation that departs materially from prescribed guidelines.

Other Financial Reporting Considerations

2.95 Chapter 16 discusses the presentation of summary financial information (popular reports). Chapter 17, "Financial Statements Prepared in Accordance With a Special-Purpose Framework," discusses the presentation of financial statements prepared in accordance with a comprehensive basis of accounting other than GAAP. Financial statements presented on this basis are referred to as financial statements prepared in accordance with a special-purpose framework.

Accounting and Financial Reporting Alternatives

2.96 GASB standards permit various accounting and financial reporting alternatives. Although GASB standards do not identify any alternatives as preferable, they do state or imply that the use of certain alternatives is encouraged. Chapter 16 discusses the auditor's evaluation of a change in accounting principles relating to accounting and financial reporting alternatives that are identified as preferable and encouraged. Appendix A to this chapter, "Accounting and Financial Reporting Alternatives in GASB Statement No. 34, as amended," lists certain accounting and financial reporting alternatives contained in GASB Statement No. 34, as amended, and identifies those alternatives that are encouraged. Other accounting and financial reporting alternatives that are permitted are described in other GASB standards. General disclosure standards regarding accounting and financial reporting alternatives are noted in paragraph 2.48.

2.97

Appendix A—Accounting and Financial Reporting Alternatives in GASB Statement No. 34, as Amended

GASB Statement No. 34, as amended, includes numerous accounting and financial reporting alternatives, which are provisions that permit an unconditional choice between two or more approaches. In many situations, that statement encourages the use of one alternative over another. Table A-1 lists those alternatives and identifies those that are encouraged with a checkmark. This appendix includes some requirements from the transition section of GASB Statement No. 34 because they have ongoing effect on a government's financial statements.

Table A-1

GASB Statement No. 34 Accounting and Financial Reporting Alternatives, as Amended

Topic	*Description of Alternative Methods and Presentations*	*Encouraged*	*References in GASB Statement No. 34, as amended*
MD&A	• Using charts, graphs, and tables is encouraged to enhance the understandability of management's discussion and analysis (MD&A).	✓	paragraph 9
Government-wide financial statements (GWFS)	• A total column for the reporting entity as a whole may or may not be presented.		paragraph 14
	• Prior-year data may or may not be presented.		paragraph 14
GWFS—statement of net position	**Presentations**		
	• Presenting the statement using a net position format, rather than a balance sheet format, is encouraged.	✓	paragraph 30, as amended
	• Presenting assets and liabilities in order of their relative liquidity, rather than classifying them as between current and long-term, is encouraged.	✓	paragraph 31 and footnote 23
	Capital assets		
	• Accumulated depreciation may be reported on the face of the statement of net position or disclosed in the notes.		paragraph 20, as amended

GASB Statement No. 34 Accounting and Financial Reporting Alternatives as Amended—*continued*

Topic	*Description of Alternative Methods and Presentations*	*Encouraged*	*References in GASB Statement No. 34, as amended*
	• Capital assets may be reported in detail, such as by major class of asset—for example, infrastructure, buildings and improvements, vehicles, machinery and equipment (although disclosure of the details is required).		paragraph 20, as amended
GWFS—statement of activities	**Level of detail**		
	• Presenting data at a more detailed level than by function (for governmental activities) or different identifiable activities (for business-type activities) is encouraged if that presentation provides more useful information without reducing understandability.	✓	paragraph 40
	• Presenting a statement of activities as supplementary information other than required supplementary information (known as "GASB defined" SI) is encouraged by GASB for (*a*) governments that want to present disaggregated data for their multiple-function enterprise funds beyond what is required for segment reporting and (*b*) special-purpose governments engaged only in business-type activities.	✓	paragraph 123
	Indirect expenses		
	• None, some, or all indirect expenses may be allocated among functions.		paragraph 42
	• If indirect expenses are allocated, a column totaling direct and indirect expenses may or may not be presented.		paragraph 42

(continued)

GASB Statement No. 34 Accounting and Financial Reporting Alternatives as Amended—*continued*

Topic	***Description of Alternative Methods and Presentations***	***Encouraged***	***References in GASB Statement No. 34, as amended***
	• Administrative overhead charges for "centralized" expenses may be eliminated or not. Disclosure is required if those charges are not eliminated.		paragraph 43
	Depreciation expense		
	• Depreciation expense on noninfrastructure capital assets that serve essentially all functions may be (*a*) allocated ratably as a direct expense among functions, (*b*) reported as a separate line item, or (*c*) reported in an "indirect" function (such as "general government"). A disclosure is required on the face of the statement if a separate line item is used.		paragraph 44
	• Depreciation expense on general infrastructure assets may be reported as a direct expense of the function associated with capital outlay or as a separate line item.		paragraph 45
Fund classification	• An enterprise fund may or may not be used to report any activity for which a fee is charged to external users for goods or services. (There are three situations in which the use of an enterprise fund is required.)		paragraph 67
	• An internal service fund may or may not be used to report any activity that provides goods or services to other funds, departments, or agencies of the primary government or its component units, or to other governments. However, to use an internal service fund, the reporting government has to be the predominant participant in the activity.		paragraph 68

GASB Statement No. 34 Accounting and Financial Reporting Alternatives as Amended—*continued*

Topic	*Description of Alternative Methods and Presentations*	*Encouraged*	*References in GASB Statement No. 34, as amended*
Major funds	• Any governmental or enterprise fund that the government's officials believe is particularly important to financial statement users may be presented as a major fund. (There is a two-step test for determining which governmental and enterprise funds are required to be reported as major funds.)		paragraph 76
Governmental fund financial statements	• The financial position statement, nonspendable fund balance may be presented separately or in the aggregate. Restricted, committed, and assigned fund balance may be presented in the aggregate for each classification or presented with additional information within the respective fund balance classification. Specific detailed information should be disclosed in the notes to the financial statements for information presented in the aggregate on the financial position statement.		paragraph 84, as amended
Proprietary fund financial statements	• The financial position statement may be presented using either a net position format or a balance sheet format.		paragraph 91, as amended, footnote 39, and paragraph 98, as amended
	• Revenues may be reported either (*a*) net of discounts and allowances with the discount or allowance amount presented parenthetically in the financial statement or in a note to the financial statements or (*b*) gross with the related discounts and allowances reported directly below the revenue amount.		paragraph 100, as amended, footnote 41

(continued)

GASB Statement No. 34 Accounting and Financial Reporting Alternatives as Amended—*continued*

Topic	*Description of Alternative Methods and Presentations*	*Encouraged*	*References in GASB Statement No. 34, as amended*
Fiduciary fund financial statements	• The components of net position—net investment in capital assets; restricted; and unrestricted—may or may not be presented in the statement of fiduciary net position. (Other GASB statements require specific net position presentations for certain fiduciary funds.)		paragraph 108, as amended
Infrastructure assets	• Networks or subsystems of networks of infrastructure assets may be reported by using the modified approach or by reporting depreciation expense. (Two requirements for using the modified approach have to be met.)	✓	paragraph 23
	• For infrastructure assets reported using the modified approach, condition assessments may be performed using statistical samples and may be performed on a cyclical basis.		paragraph 24, footnote 19
	• Governments that do not use the modified approach but gather the information required to be presented as required supplementary information (RSI) were they to use that approach are encouraged to provide that information as SI.		paragraph 133, footnote 58
	• Phase 1 and 2 governments (those with total annual revenues of $10 million or more in the first fiscal year ending after June 15, 1999) may limit retroactive reporting of general infrastructure assets to major general infrastructure assets acquired, renovated, restored, or improved in fiscal years ending after June 30, 1980.[1]		paragraphs 148, as amended, 154, and 156

[1] Similar guidance concerning the retroactive reporting of general infrastructure assets is provided in GASB Statement No. 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities—an amendment of GASB Statement No. 34*, paragraph 10.

GASB Statement No. 34 Accounting and Financial Reporting Alternatives as Amended—*continued*

Topic	*Description of Alternative Methods and Presentations*	*Encouraged*	*References in GASB Statement No. 34, as amended*
	• Phase 3 governments (those with total annual revenues of less than $10 million in the first fiscal year ending after June 15, 1999) are not required to retroactively report general infrastructure assets.[2]		paragraph 148, as amended
	• Phase 3 governments may retroactively report major general infrastructure assets and all governments, including phase 3 governments, may retroactively report all general infrastructure assets.	✓	paragraphs 148, as amended, and 156
	• If the actual historical cost of existing major general infrastructure assets is not practically determinable, historical cost may be estimated using any approach that complies with the intent of GASB Statement No. 34.		paragraph 155
Works of art, historical treasures, and similar assets	• Capitalization is encouraged, but not required, for collections that are not capitalized at June 30, 1999, and that are (*a*) held for public exhibition, education, or research in furtherance of public service, rather than financial gain; (*b*) protected, kept unencumbered, cared for, and preserved; and (*c*) subject to an organizational policy that requires the proceeds from sales of collection items to be used to acquire other items for collections.	✓	paragraph 27 and footnote 22
Depreciation	• Any established depreciation method may be used, including composite methods.		paragraphs 22, 161, 163, and 164

(continued)

[2] See footnote 1 in this appendix.

GASB Statement No. 34 Accounting and Financial Reporting Alternatives as Amended—*continued*

Topic	*Description of Alternative Methods and Presentations*	*Encouraged*	*References in GASB Statement No. 34, as amended*
	• Depreciation may be based on the estimated useful life of a class of assets, a network of assets, a subsystem of a network, or individual assets.		paragraphs 22 and 161
	• For estimated useful lives, governments can use (1) general guidelines obtained from professional or industry organizations, (2) information for comparable assets of other governments, or (3) internal information.		paragraph 161
Proprietary Fund Accounting—Regulated Operations	• The provisions of paragraphs 476–500, "Regulated Operations" of GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, may be applied to qualifying enterprise funds meeting the criteria for reporting as regulated enterprises.		paragraph 95, as amended
Budgetary information	• Governments that present budgetary comparison information for the general fund and for each major special revenue fund are encouraged to present such information as part of RSI, rather than as a basic financial statement.	✓	paragraph 130 and footnote 53, as amended
	• Reporting the variance between the final budget and actual amounts is encouraged but not required.	✓	paragraph 130, as amended
	• The variance between original and final budget amounts may or may not be presented.		paragraph 130, as amended

GASB Statement No. 34 Accounting and Financial Reporting Alternatives as Amended—*continued*

Topic	*Description of Alternative Methods and Presentations*	*Encouraged*	*References in GASB Statement No. 34, as amended*
	• Budgetary comparison schedules may be presented using (*a*) the same format, terminology, and classifications as in the budget document or (*b*) the format, terminology, and classifications in a statement of revenues, expenditures, and changes in fund balances.		paragraph 131, as amended
	• If the budgetary comparison schedules are presented as RSI, required information that reconciles budgetary information to generally accepted accounting principles information may be presented either in a separate RSI schedule or in notes to RSI.		paragraph 131, as amended
Component unit financial information	• Information required by paragraph 51 of GASB Statement No. 14, *The Financial Reporting Entity*, as amended, about each major component unit can be provided by (*a*) presenting each major component unit in a separate column in the GWFS, (*b*) including combining statements of major component units in the basic statements after the fund financial statements, or (*c*) presenting condensed financial statements in the notes to the financial statements. Information for nonmajor, discretely presented, component units should be presented in the aggregate.		paragraph 126, as amended, and footnote 50

(continued)

GASB Statement No. 34 Accounting and Financial Reporting Alternatives as Amended—*continued*

Topic	***Description of Alternative Methods and Presentations***	***Encouraged***	***References in GASB Statement No. 34, as amended***
Single-program governments	• Special-purpose governments engaged in a single governmental program may combine their GWFS and fund financial statements using a columnar format that reconciles individual line items of fund financial data to government-wide data in a separate column on the face of the financial statements. Descriptions of reconciling items should be presented either on the face of the financial statements, in an accompanying schedule, or in the notes to the financial statements.		paragraph 136, as amended, and footnote 62
	• If special-purpose governments engaged in a single governmental program present separate GWFS and fund financial statements, they may present their government-wide statement of activities using a different format (such as a single column format).		paragraph 136, as amended
"Not-for-profit" governments	• Governments that reported as of June 30, 1999, using the AICPA Not-for-Profit model as defined in GASB Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities,* but that do not meet the GASB Statement No. 34 criteria for the use of an enterprise fund, may nevertheless use enterprise fund accounting and financial reporting.		paragraph 147, as amended

GASB Statement No. 34 Accounting and Financial Reporting Alternatives as Amended—*continued*

Topic	*Description of Alternative Methods and Presentations*	*Encouraged*	*References in GASB Statement No. 34, as amended*
Public employee retirement system (PERS) reporting	• PERS that administer more than one defined benefit pension plan that is administered through a trust that meets the specified criteria or OPEB plan that is administered through a trust that meets the specified criteria should (*a*) present a separate column for each plan administered on its financial statements or (*b*) present combining statements for those plans as part of its basic financial statements.		paragraph 140, as amended
	• For all plans other than defined benefit pension plans or OPEB plans that are provided through a trust that meets the specified criteria, a PERS is encouraged to present combining financial statements.	✓	paragraph 141, as amended

Chapter 3

The Financial Reporting Entity

Introduction

3.01 Many governmental financial statements include the financial data of more than a single legal entity. GASB Statement No. 14, *The Financial Reporting Entity*, as amended, contains the standards for defining the governmental financial reporting entity and for identifying which legally separate entities are component units that should be included with another government (usually a primary government) in a financial reporting entity's financial statements. Requirements for including component units are based primarily on the concept of financial accountability, where elected officials are accountable to citizens for their public policy decisions, regardless of whether those decisions are carried out directly by the elected officials through the operations of the primary government or by their designees through the operations of specially created organizations.

3.02 GASB Statement No. 14, as amended, also contains standards for displaying component units in a financial reporting entity's basic financial statements. The statement contains a concept of discrete presentation that separates the financial information of most component units from the financial information of the primary government. However, the financial information of some component units is blended with the financial information of the primary government.

3.03 The purpose of this chapter is to discuss the major elements of the financial reporting entity definition and related reporting matters to consider in planning, performing, evaluating the results of, and reporting on the audit. Refer to GASB Statement No. 14, as amended, for a discussion of the governmental financial reporting entity and to GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, as amended, for guidance on the form and content of the basic financial statements to be issued by all state and local governmental entities. Additional guidance is provided in paragraphs 9 and 13 of the GASB *Implementation Guide No. 2015-1* (GASB IG 2015-1), including nonauthoritative appendixes that provide illustrative examples, disclosures, and financial statement presentations for the financial reporting entity and component units.

GASB's Financial Reporting Entity Standards

3.04 The requirements of GASB Statement No. 14, as amended, apply to all state and local governments and to the financial reporting of the following:

- Primary governments
- The separately issued financial statements of a governmental component unit
- Governmental joint ventures

- Jointly governed organizations
- Other stand-alone governments[1]

In addition, GASB Statement No. 14, as amended, should be applied to all governmental and nongovernmental component units when they are included in a governmental financial reporting entity and to the separately issued financial reports of governmental component units (see GASB IG 2015-1 questions 4.2.1–4.2.2).

Definition of the Financial Reporting Entity

3.05 The governmental financial reporting entity consists of the following:

- The primary government
- Organizations for which the primary government is financially accountable
- Other organizations that do not meet the financial accountability criteria but for which the nature and significance of their relationship with the primary government are such that, based on the exercise of management's professional judgment, exclusion would cause the financial reporting entity's financial statements to be misleading

The nucleus of a financial reporting entity usually is a primary government. However, a government other than a primary government (such as a component unit, a joint venture, a jointly governed organization, or another stand-alone government) serves as the nucleus for its own financial reporting entity when it issues separate financial statements, and the requirements of GASB Statement No. 14, as amended, should be applied as if it were a primary government.

3.06 GASB Statement No. 14 paragraph 13 defines a *primary government* as any state government or general-purpose local government (for example, a municipality or county). A primary government also is a special-purpose government (for example, a school district or a park district) that meets all of the following criteria:

- It has a separately elected governing body.
- It is legally separate (see GASB Statement No. 14 paragraph 15).
- It is fiscally independent of other state and local governments (see paragraph 3.07).

The primary government consists of all funds, organizations, institutions, agencies, departments, and offices that make up the legal entity. GASB Statement No. 14 paragraph 19, as amended, states that the primary government also consists of funds for which it has a fiduciary responsibility, even though those funds may represent organizations that do not meet the definition for inclusion in the financial reporting entity.

3.07 A special-purpose government is fiscally independent if it has the authority to do all three of the following:

- Determine its budget without another government's having the authority to approve and modify that budget

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[1] Other stand-alone governments are legally separate governments that (*a*) do not have a separately elected governing body and (*b*) do not meet the definition of a component unit. Other stand-alone governments include some special-purpose governments, joint ventures, jointly governed organizations, and pools.

- Levy taxes or set rates or charges without approval by another government
- Issue bonded debt without approval by another government

3.08 Component units are legally separate organizations (whether governmental, not-for-profit, or for-profit organizations) for which elected officials of the primary government are financially accountable. In addition, component units can be other organizations for which the nature and significance of their relationship with a primary government are such that exclusion would cause the reporting entity's financial statements to be misleading. GASB Statement No. 14 paragraph 21, as amended, states the following about a primary government's financial accountability for a legally separate organization:

- A primary government is financially accountable if it appoints a voting majority of the organization's governing body and (*a*) it is able to impose its will on that organization or (*b*) there is a potential for the organization to provide specific financial benefits to, or impose specific financial burdens on, the primary government. (See the discussion in paragraph 3.09.)
- The primary government is financially accountable if an organization is fiscally dependent upon it and there is a potential for the organization to provide specific financial benefits to, or impose specific financial burdens on, the primary government regardless of whether the organization has (*a*) a separately elected governing board, (*b*) a governing board appointed by a higher level of government, or (*c*) a jointly appointed board. (An organization that is not fiscally independent is fiscally dependent on the primary government that holds one or more of the powers listed in paragraph 3.07.) See GASB Statement No. 14 paragraphs 34–38, as amended.

3.09 GASB Statement No. 14 paragraph 26 states that a primary government has the ability to impose its will on an organization if it can significantly influence the programs, projects, activities, or level of services performed or provided by the organization. It provides a list of conditions that indicate that ability. Further, GASB Statement No. 14 paragraph 27, as amended, states that an organization can provide a financial benefit to, or impose a financial burden on, a primary government in a variety of ways and indicates that an organization has a financial benefit or burden relationship with a primary government if, for example, any one of the following conditions exist:

- The primary government is legally entitled to or can otherwise access the organization's resources.
- The primary government is legally obligated or has otherwise assumed the obligation to finance the deficits of, or provide financial support to, the organization.
- The primary government is obligated in some manner for the debt of the organization.

GASB Statement No. 14, as amended, provides a detailed discussion of those three manifestations of a financial benefit or burden relationship.

3.10 GASB Statement No. 14, as amended, also requires certain organizations to be included as component units if the nature and significance of their relationship with the primary governments are such that excluding them would render the financial reporting entity's financial statements misleading. GASB Statement No. 14 paragraph 40 refers to certain authorities that are created to provide temporary fiscal assistance to a local government. GASB Statement No. 39, *Determining Whether Certain Organizations Are Component Units—an amendment of GASB Statement No. 14*, paragraph 5 (which added paragraph 40a to GASB Statement No. 14), provides further guidance, stating that a legally separate, tax-exempt organization should be reported as a component unit if all of the following criteria are met:

- The economic resources received or held by the separate organization are entirely or almost entirely for the direct benefit of the primary government, its component units, or its constituents.
- The primary government, or its component units, is entitled to, or has the ability to otherwise access,[2] a majority of the economic resources received or held by the separate organization.
- The economic resources received or held by an *individual organization* that the specific primary government, or its component units, is entitled to, or has the ability to otherwise access, are significant to that primary government. (Note that this *significance* criterion applies only to the legally separate, tax-exempt organizations that meet the other two criteria listed here, and not to the evaluation of the inclusion of other component units in the financial reporting entity.)

In addition, paragraph 41 of GASB Statement No. 14, as amended, states that other organizations should be evaluated as potential component units if they are closely related to,[3] or financially integrated[4] with, the primary government. It is a matter of professional judgment to determine whether the nature and the significance of a potential component unit's relationship with the primary government warrant inclusion in the reporting entity.

3.11 If a governmental entity owns a majority of the equity interest in a legally separate organization (for example, through acquisition of its voting stock), the governmental entity's intent for owning the equity interest should determine whether the organization should be presented as a component unit or an investment of the governmental entity. If the governmental entity's intent for owning a majority equity interest is to directly enhance its ability to provide governmental services, the organization should be reported as a component unit.[5]

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[2] GASB Statement No. 39, *Determining Whether Certain Organizations Are Component Units—an amendment of GASB Statement No. 14*, states that a primary government's "ability to otherwise access" may be demonstrated in several ways and provides some examples, including a primary government historically receiving, directly or indirectly, a majority of the economic resources provided by the organization.

[3] For purposes of this evaluation, the focus generally would be on financial relationships.

[4] GASB Statement No. 39 states that "financial integration may be exhibited and documented through the policies, practices, or organizational documents of either the primary government or the organization being evaluated as a potential component unit." The nonauthoritative basis for conclusions of GASB Statement No. 39 paragraph 34 provides examples of financial integration.

[5] For example, in paragraph 55 of GASB Statement No. 14, *The Financial Reporting Entity*, as amended, a government that purchases 100 percent of the stock of a concrete plant to provide a controlled source of concrete for its capital projects should report the concrete company as a component unit. When such a component unit is discretely presented, the equity interest should be reported as an asset of the fund that has the equity interest (subject to reporting requirements for governmental

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3.12 A nonauthoritative flowchart in appendix C of GASB Statement No. 61 aids in the evaluation of whether an entity is a component unit of a particular financial reporting entity.

Financial Statement Presentation

3.13 GASB Statement No. 14, as amended, requires financial statement presentation that permits financial statement users to distinguish between the primary government and its component units.[6] Some component units have close relationships with the primary government, and their financial statements should be blended as if they were part of the primary government. (See paragraphs 3.14–.16.) However, the financial data for most component units should be discretely presented. (See paragraph 3.17.)

3.14 GASB Statement No. 14, as amended, explains that with blending, a component unit's balances and transactions are reported in a manner similar to the balances and transactions of the primary government itself. That is, for accounting and financial reporting purposes, blended component units generally should be treated the same as the funds of the primary government. For example, the funds of a blended component unit should be included in the appropriate fund financial statements (and combining and individual fund financial statements, if presented as "GASB defined" supplementary information (SI)[7,8]) of the primary government, and presented as major governmental or enterprise funds if they meet the major funds criteria.[9] However, the general fund of a blended component unit should be reported as a special revenue fund. The financial data of blended component units also should be included with the primary government's financial data in the government-wide financial statements.

3.15 For governments engaged only in business-type activities that use a single column for financial statement presentation, a component unit that meets the criteria for blending may be included by consolidating its financial

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(footnote continued)

funds). When such a component unit is blended, in the period of acquisition, the purchase typically should be reported as an outflow of the fund that provided the resources for the acquisition. Additionally, in that and subsequent reporting periods, the component unit should be reported pursuant to the blending requirements of paragraph 54 of GASB Statement No. 14, as amended. If, however, the government owns the equity interest for the purpose of obtaining income or profit rather than to directly enhance its ability to provide governmental services, it should report its equity interest as an investment regardless of the extent of its ownership.

[6] GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, as amended, provides that component units that are fiduciary in nature should be reported in the primary government's fund financial statements only (in the statements of fiduciary net position and changes in fiduciary net position), where those data are included with the appropriate fiduciary fund type. Those component units are treated the same as fiduciary funds and are therefore referred to in this guide as fiduciary funds. This guide refers to component units that are not fiduciary in nature as blended component units or discretely presented component units. See also question 4.27.1 of the GASB *Implementation Guide No. 2015-1* (GASB IG 2015-1), which clarifies that there are three types of component units—blended, discretely presented, and fiduciary.

[7] Chapter 4, "General Auditing Considerations," and chapter 16, "Audit Reporting," discuss the auditor's responsibility for and reporting on supplementary information (SI) and other information.

[8] This guide uses the term "*GASB defined*" *SI* to refer to supplementary information other than required supplementary information, which some governments present with their basic financial statements. See chapter 2, "Financial Reporting," for more information.

[9] Chapter 2 discusses the major funds criteria.

statement data within the single column of the primary government and presenting condensed combining information in the notes to the financial statements. GASB Statement No. 14 paragraph 54a, as amended, provides the minimum presentation for the condensed combining information.

3.16 GASB Statement No. 14, as amended, requires the use of the blending method for a component unit in any of these circumstances:

- *a.* The component unit's governing body is substantively the same[10] as the governing body of the primary government, and (1) there is a financial benefit or burden relationship between the component unit and the primary government or (2) management of the primary government has operational responsibility for the component unit.

  Management of a primary government has operational responsibility for a component unit if it manages the activities of the component unit in essentially the same manner in which it manages its own programs, departments, or agencies. Management, for purposes of this determination, consists of the person(s) below the level of the governing board who are responsible for the day-to-day operations of the primary government (for example, a county executive or city manager).
- *b.* The component unit provides services entirely, or almost entirely, to the primary government or otherwise exclusively, or almost exclusively, benefits the primary government even though it does not provide services directly to it. (Paragraph 3.18 discusses an exception to this second condition.)
- *c.* The component unit's total debt outstanding, including leases, is expected to be repaid entirely or almost entirely with resources of the primary government. Repayment generally occurs through a continuing pledge and appropriation by the primary government to the component unit that, in turn, pledges those appropriation payments as the primary source of repayment for its debt.
- *d.* The component unit is organized as a not-for-profit corporation in which the primary government is the sole corporate member as identified in the component unit's articles of incorporation or bylaws.[11]

3.17 Component units are included in the financial reporting entity by discrete presentation if they do not meet the criteria for blending. In addition, GASB Statement No. 39 requires that component units that meet the criteria of GASB Statement No. 14 paragraph 40a, as discussed in paragraph 3.10, be discretely presented. (GASB IG 2015-1 questions 4.30.1–4.30.2, as amended,

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[10] *Substantively the same* means sufficient representation of the primary government's entire governing body on the component unit's governing body so that decisions of the primary government cannot be overridden by the component unit. To illustrate, the board of a city redevelopment authority may be composed entirely of the city council and the mayor, serving ex officio. The primary government is, essentially, serving as the governing body of the component unit. On the other hand, the board of a public housing authority composed of the city mayor and two council members (from a total of 10) would not be substantively the same as the city's governing body. This criterion would rarely, if ever, apply to a state government because of the impracticality of providing sufficient representation of the state's entire governing body.

[11] This criterion does not apply to component units included in the reporting entity pursuant to the provisions of GASB Statement No. 39.

clarify that these component units should be discretely presented, even if they also meet a criterion for blending.) Discrete presentation generally entails reporting component unit financial data in rows and columns separate from the financial data of the primary government. All discretely presented component units should be combined in one or more columns in the government-wide financial statements only (that is, they are not also displayed in the fund financial statements). That discrete column(s) should be located to the right of the total column of the primary government, distinguishing between the financial data of the primary government (including its blended component units) and those of the discretely presented component units by providing descriptive column headings. All presentations of the financial data of discretely presented component units in the reporting entity's government-wide financial statements should be made using the economic resources measurement focus and accrual basis of accounting.

3.18 GASB Statement No. 34 paragraph 61, as amended, provides that resource flows between a primary government and its blended component units should be reported using the statement's standards for interfund and internal activity (see chapter 9, "Interfund, Internal, and Intra-Entity Activity and Balances"). In the government-wide financial statements, resource flows between a primary government and its discretely presented component units, except those that affect the statement of net position, such as loans, repayments, and deferred inflows of resources and deferred outflows of resources resulting from intra-entity transactions, should be reported as revenues and expenses. However, amounts payable and receivable between a primary government and its discretely presented component units or between those component units should be reported on a separate line.

3.19 Chapter 12, "Special-Purpose and State Governments," in the section on financing authorities, discusses the standards for reporting lease arrangements between a primary government and its component units. National Council on Governmental Accounting (NCGA) Statement 5, *Accounting and Financial Reporting Principles for Lease Agreements of State and Local Governments*, paragraphs 22–26, as amended, is the source of this guidance on reporting such lease arrangements. That chapter, in the section on state governments, also discusses the provisions of GASB Technical Bulletin No. 2004-1, *Tobacco Settlement Recognition and Financial Reporting Entity Issues* (as amended), which addresses accounting by governments in connection with settlements made by U.S. tobacco companies, including whether a Tobacco Settlement Authority that is created to obtain the rights to all or a portion of future tobacco settlement resources is a component unit of the government that created it and, if so, how to report it.

3.20 A primary government and its component units may have the same or different fiscal year-ends. If there are different fiscal year-ends, the financial reporting entity reports using the primary government's fiscal year and incorporates financial statements for the component units' fiscal years ending during the reporting entity's fiscal year. If a component unit's fiscal year ends within the first quarter of the reporting entity's subsequent fiscal year, the component unit's financial statements for that subsequent year may be used if doing so does not adversely affect the timely and accurate presentation of the reporting entity's financial statements. (Chapter 9 discusses the effect on interfund, internal, and intra-entity activity and balances when a component unit's fiscal year differs from that of its primary government.)

3.21 GASB Statement No. 14, as amended, requires the financial reporting entity's basic financial statements to include information about each major discretely presented component unit. In determining which component units are *major*, consideration should be based on the nature and significance of its relationship to the primary government. This determination generally would be based on any of the following factors:

a. The services provided by the component unit to the citizenry are such that separate reporting as a major component unit is considered to be essential to financial statement users.

b. There are significant transactions with the primary government.

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

GASB IG 2015-1 question 4.28.17 states that "no specific benchmarks for evaluating 'significance' are established in GASB Statement No. 14 because they necessarily would be arbitrary." However, the question provides examples of both qualitative and quantitative characteristics to consider. (Note that the definition of *major* for this purpose is not solely quantitative, as it is for the definition of *certain major governmental and enterprise funds*.) The alternatives for presenting the required information about each major discretely presented component unit are as follows:

- Presenting each major component unit in a separate column in the government-wide statements. (Nonmajor component units would be aggregated in a single column.)
- Including combining statements of major component units, with nonmajor units aggregated in a single column[12] as a basic financial statement after the fund financial statements.
- Presenting condensed financial statements in the notes to the basic financial statements. (Certain minimum requirements for this disclosure are provided–see paragraph 3.15.)

3.22 GASB Statement No. 14 paragraph 51, as amended, requires that the data presented for each component unit in the combining statements generally be its aggregated totals, derived from the component units' statements of net position and activities. Those aggregated totals should include amounts for the component units' own component units. (Because component units that are engaged only in business-type activities and that do not have discretely presented component units that are engaged in governmental activities[13] are not required to prepare a statement of activities, that disclosure should be taken from the information provided in the component unit's statement of revenues, expenses, and changes in net position.) Presentation of the fund financial statements of the individual component units is not required in the reporting entity's comprehensive annual financial report unless such information is not available in separately issued financial reports of the component unit. If separately issued

[12] GASB Statement No. 34 footnote 50 does not require a combining statement for the nonmajor component units as a basic financial statement. However, it states that such a combining statement may be presented as "GASB defined" SI (See chapter 2 for more information.)

[13] Question 7.97.3 of GASB IG 2015-1 indicates that a special-purpose government engaged only in business-type activities that has discretely presented component units that are engaged in governmental activities should present government-wide statements.

financial information for a component unit is not available, fund financial statements for that component unit should be presented as "GASB defined" SI.[14]

Disclosures

3.23 GASB Statement No. 14 paragraphs 62–63, as amended, require the notes to the financial statements to distinguish between information pertaining to the primary government (including its blended component units) and that of its discretely presented component units. Notes essential to fair presentation in the financial reporting entity's basic financial statements encompass (*a*) governmental and business-type activities, major funds individually, and nonmajor funds in the aggregate of the primary government (including its blended component units) and (*b*) major discretely presented component units considering the nature and significance of the unit's relationship to the primary government. Determining which discretely presented component unit disclosures are essential to fair presentation is a matter of professional judgment and should be done on a component unit-by-component unit basis.

3.24 The notes to the financial reporting entity's financial statements also should include the following disclosures concerning component units as required by GASB Statement No. 14 (paragraphs 60–61), as amended, and No. 34 (paragraph 128):

- A brief description of the component units of the financial reporting entity and their relationships to the primary government, including a discussion of the rationale for including the component units in the financial reporting entity and whether it is discretely presented, blended, or included in the fiduciary fund financial statements.
- Information about how the separate financial statements for the individual component units may be obtained
- If transactions between component units that have different fiscal years result in inconsistencies in amounts reported between the primary government and its component units, the nature and amount of those transactions
- Changes in fiscal years of component units
- The nature and amount of significant transactions that each major component unit has with the primary government and other component units

3.25 GASB Statement No. 14, paragraph 68, and GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, as amended, paragraphs 55–56, require a primary government to disclose in the notes to the financial statements the nature of its accountability for related organizations and certain transactions with related parties, respectively. Related organizations include those for which the primary government is accountable because it appoints a voting majority of the board, but for which that same primary government is not financially accountable. Groups of related organizations with

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[14] GASB IG 2015-1 questions 4.33.1–4.33.4 describe how a reporting entity would display the financial statements of a component unit that uses a generally accepted accounting principles (GAAP) reporting model other than the governmental model (such as the nongovernmental not-for-profit model).

similar relationships with the primary government may be summarized for purposes of that disclosure. In addition, the primary government should disclose related-party transactions between the government and its (*a*) related organizations; (*b*) joint ventures and jointly governed organizations; (*c*) elected and appointed officials, management, or members of their immediate families; and (*d*) trusts for the benefit of employees that are managed by, or under the trusteeship of, the government's management. GASB Statement No. 14 paragraph 68 further requires the financial statements of a related governmental organization to disclose the primary government that is accountable for it and describe its relationship with that primary government. (Chapter 4, "General Auditing Considerations," and chapter 15, "Concluding the Audit," discuss the reporting of and audit considerations for related-party transactions.)

Other Financial Reporting Requirements

3.26 GASB Statement No. 14 paragraph 62 states that required supplementary information (RSI) should distinguish between information pertaining to the primary government (including its blended component units) and that of its discretely presented component units. Further, GASB Statement No. 34 paragraph 10 provides that, although the management's discussion and analysis (MD&A) should focus on the primary government, the MD&A should, when appropriate, include information pertaining to component units. That paragraph states that

> determining whether to discuss matters related to a component unit is a matter of professional judgment and should be based on the individual component unit's significance to the total of all discretely presented component units and that component unit's relationship with the primary government. When appropriate, the financial reporting entity's MD&A should refer readers to the component unit's separately issued financial statements.

(Chapters 4 and 16, "Audit Reporting," discuss the auditor's responsibility for and reporting on RSI.)

3.27 GASB Statement No. 14 paragraph 64 states that if financial statements are issued that present only the data of the primary government, they should acknowledge that they do not include the data of the component units necessary for reporting in conformity with generally accepted accounting principles (GAAP). (Chapter 16 discusses the effect of that situation on the auditor's report.)

3.28 GASB Statement No. 14 paragraph 65 states that a component unit may serve as a nucleus for a financial reporting entity when it issues separate financial statements and should apply the provisions of GASB Statement No. 14, as amended. However, those separate financial statements should acknowledge that the government is a component unit of another government—for example, the title "Sample County School District, a component unit of Sample County." In addition, the notes to the financial statements should identify the primary government in whose financial reporting entity the component unit is included and describe its relationship with the primary government.[15]

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[15] As discussed in chapter 16, the auditor's report on the component unit's separate financial statements also should disclose information that the entity is a component unit of a financial reporting entity.

3.29 GASB Statement No. 14, as amended, also discusses the financial statement presentation and disclosure requirements pertaining to a financial reporting entity's relationships with the following types of organizations:

- Joint ventures
- Jointly governed organizations
- Component units and related organizations with joint venture characteristics
- Pools
- Undivided interests
- Cost-sharing arrangements
- Investments in for-profit corporations (when purchased to directly aid in the provision of governmental services)

Auditing Considerations

Reporting Entity

3.30 The audit objectives relating to the definition, financial statement presentation, and disclosure of the financial reporting entity are as follows:[16]

- Components of the financial reporting entity, as defined in AU-C section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* (AICPA, *Professional Standards*), are properly identified and group audit requirements fulfilled. The term *component*, for applying the provisions of AU-C-section 600 is different from the term *component unit*, as defined by GASB. See chapter 4 for a discussion of group audit considerations when performing audits of governmental entities.
- The component units reported in the financial statements meet the criteria for inclusion in the financial reporting entity and are properly presented.
- All funds of the primary government and all component units are included in the financial reporting entity.
- If a component unit's fiscal year differs from that of the primary government, component unit information for the proper fiscal year is included in the financial reporting entity's financial statements.
- The component units' assets, deferred outflows of resources, liabilities, deferred inflows of resources, and net position presented in the financial reporting entity financial statements are consistent in amount and classification with their presentation in the separately issued component unit financial statements, if applicable,

[16] Similar audit objectives also relate to audits of the separately issued financial statements of governmental component units, joint ventures, jointly governed organizations, and other stand-alone governments.

and consistent with the classification of similar items in the reporting entity's financial statements.[17]

- Financial statement presentation and disclosures for component units and related organizations are prepared under the same financial reporting framework.[18]

Internal Control Over Financial Reporting

3.31 The auditor should obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit likely relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit. When obtaining an understanding of controls, the auditor should evaluate the design of the controls and determine whether they have been implemented by performing procedures in addition to the inquiry of the government's personnel. Obtaining this understanding includes a government's internal control over financial statement presentation and disclosures relating to the financial reporting entity. Those control features may include the following:

- Annual consideration and supervisory review that all of the primary government's funds are included in its financial statements.
- Annual consideration and supervisory review of the potential component units and related organizations for reporting in the financial reporting entity's financial statements (including issues of inclusion, identification of major component units, method of presentation, and disclosure), including the need for changes in the presentation of component units since the prior-year financial statements because of changes in legal and contractual provisions that affect the operation of potential component units.
- Procedures to communicate financial reporting requirements and results between the primary government and each of its component units and their separate auditors, if applicable. (See chapter 4 for discussion of group audit requirements.) Primary governments sometimes obtain the information they need for financial reporting from their component units by having the component units complete a "reporting package" that provides the required information.
- Procedures to appropriately incorporate component unit financial data into the financial reporting entity financial statements, including the notes thereto, and to appropriately disclose related entities.

Audit Procedures

3.32 Audit procedures relating to the financial reporting entity may include the following:

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[17] The presentation of component unit financial information in the reporting entity's financial statements need not be identical to its presentation in the component unit's financial statements, but any reclassification of component unit financial information should not distort the presentation of the component unit's financial information.

[18] The GASB financial reporting framework allows certain nongovernmental component units, such as foundations, that report under the FASB financial reporting framework, to be incorporated into the reporting entity's financial statements.

- Asking management about the existence of potential component units, including whether the entity might have component units like those reported by similar governments
- Reviewing and evaluating that all of the government's funds are included in the primary government's financial statements
- Reviewing and evaluating the government's analysis of potential component units and related organizations for reporting in the financial reporting entity financial statements (including method of inclusion, identification of major component units, method of presentation, and disclosure)
- Examining the entity's organization chart, governing board minutes, amounts paid to other entities, local newspaper articles, the entity's website, statutes and ordinances, and other similar documents for evidence of funds, potential component units, and other related organizations that have not been reported in the financial reporting entity's financial statements as required by GAAP
- Consulting with legal counsel, officials with oversight of local government audits, and other appropriate monitoring or oversight officials (such as the state attorney general, state auditor, or auditor general), as needed, to evaluate whether potential component units are legally separate entities
- Examining the entity's incorporation of component unit financial data into the financial reporting entity financial statements, including the notes thereto, as well as its inclusion of primary government funds and its disclosure of related entities

3.33 During the planning stages of an audit, the auditor should assess whether the entity has properly identified its component units. This is important to ensure, for example, that

- major funds (the calculation of which is affected by blended component units) and opinion units are appropriately identified. (See the discussion of opinion units in chapter 4.)
- the audit is properly coordinated. Delivery deadlines need to be established so that component unit audits are completed in time for those financial statements to be included in the financial reporting entity's financial statements. Some component units may not be audited. If that is the case, the component unit or primary government could arrange for a timely audit, or the group auditor, as defined by AU-C section 600, should consider having a discussion with the primary government about the potential effect on the auditor's report on the reporting entity's basic financial statements of having an unaudited component unit. (See chapter 4 for discussion of group audit requirements.)
- appropriate audit personnel or consultants are available for those component units that require expertise on issues such as health care, insurance, and actuarial matters.
- the component unit has adopted, or plans to adopt, any GASB statements that are directly required by the provisions of those statements. For example, certain GASB pronouncements provide for a staggered effective date based on entity size. Such standards generally require component units, regardless of their size,

to adopt the standard in the same year as the primary government for inclusion in the financial statements of the primary government's financial reporting entity.

Separate Component Unit Auditor

3.34 A component unit's auditor may not be the same as the primary government's auditor (that is, the auditor of the group financial statements). Because a component unit is likely to meet the definition of a component, as defined by AU-C section 600, auditors of financial statements that include component units should consider the guidance in AU-C section 600. Chapter 4 provides a discussion of group audit requirements, and chapter 16 provides a discussion of group audit reporting considerations.

Presentation of Less Than a Complete Financial Reporting Entity

3.35 Some governments issue financial statements that present less than a complete financial reporting entity. For example, they issue financial statements for the primary government only, one or more individual funds, departments, agencies, or programs. Further, some governments issue financial statements that omit one or more funds. Chapter 16 discusses the effects of those situations on the auditor's report.

Departures of Component Unit Information From GAAP

3.36 In some situations, component unit information in a financial reporting entity's financial statements might not be in accordance with GAAP. Consider these examples:

- A component unit is omitted or an included organization does not meet the provisions of GASB Statement No. 14, as amended, for inclusion as a component unit.
- The component unit's auditor has modified his or her opinion on the unit's separately issued financial statements because of a departure from GAAP or reported that the component unit's financial statements are presented on a comprehensive basis of accounting other than GAAP.
- Information about a major component unit as required by GASB Statement No. 14 paragraph 51, as amended, is not included.
- The component unit is presented using the wrong inclusion method (that is, using discrete presentation instead of blending or vice versa).
- Note disclosures for a discretely presented component unit as required by GASB Statement No. 14 paragraphs 62–63, as amended, are omitted or incomplete.

When such a GAAP departure exists, the auditor should exercise professional judgment to evaluate whether the effect of that departure is material to the financial statements of the opinion unit in which the component unit is reported. If the GAAP departure is considered material, the auditor should appropriately modify the opinion. See the discussion in chapter 16 about the effect of GAAP departures in a component unit's financial information on the auditor's report.

Nongovernmental Component Unit Use of Private-Sector Standards

3.37 It is possible that the financial information of a discretely presented component unit will be presented in the reporting entity financial statements using private-sector accounting and financial reporting standards because the component unit is not a governmental entity. (Several questions in the GASB IG 2015-1, such as questions 4.33.1–4.33.4, discuss the display of nongovernmental component units in the governmental financial reporting entity financial statements.) Although there is no specific GASB requirement to do so, the reporting entity could disclose the component unit's use of nongovernmental standards following the note disclosure requirements of NCGA Statement 1, *Governmental Accounting and Financial Reporting Principles*, and GASB Statement No. 62 as well as GASB Statement No. 14, as amended. (Appendix B4-45 of the GASB IG 2015-1 provides a nonauthoritative example of such a disclosure.)[19]

Changes in the Financial Reporting Entity

3.38 As discussed in chapter 2, "Financial Reporting," GASB Statement No. 62 provides financial reporting requirements, including disclosure requirements, when there is a change in the financial reporting entity, such as one resulting from a change in the component units included in the financial reporting entity. According to paragraph .11 of AU-C section 708, *Consistency of Financial Statements* (AICPA, *Professional Standards*), when a change results in financial statements that, in effect, are those of a different reporting entity, the auditor should include an emphasis-of-matter paragraph that describes the changes and references the disclosures, unless the change results from a transaction or event (for example, the creation, cessation, or complete or partial disposition of a subsidiary or other business unit).

Other Component Unit Auditing Considerations

3.39 Chapter 16 discusses the following additional considerations (*a*) a component unit's adoption of an accounting principle earlier than its adoption by the primary government, (*b*) the inclusion of an unaudited component unit in the financial reporting entity's financial statements, and (*c*) the effect of another auditor's work on RSI and SI under AU-C section 730, *Required Supplementary Information*, and AU-C section 725, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*), respectively.

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[19] Sometimes a primary government has financial accountability for a nongovernmental component unit that reports under a different financial reporting framework than GAAP for state and local governments. AU-C section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* (AICPA, *Professional Standards*), permits reference to the audit of a component auditor in the auditor's report on the group financial statements when the component's financial statements are prepared using a different financial reporting framework than that used for the group financial statements, if certain conditions are met.

Chapter 4

General Auditing Considerations

There are similarities, but important differences, between how GASB defines supporting information and how the AICPA auditing standards refer to that same information. The following is intended to clarify the two standard-setters' descriptions of the information and how the information will be referred to in this guide.

According to GASB Concepts Statement No. 3, *Communication Methods in General Purpose External Reports That Contain Basic Financial Statements*, supporting information places basic financial statements and notes to basic financial statements in an appropriate operational, economic, or historical context. The information is either (1) required by GASB as required supplementary information (RSI) to be presented with the basic financial statements and the notes thereto; (2) supplementary information (SI), which is required by law or regulation to be presented; or (3) SI presented at the election of the preparer. SI as contemplated in GASB Concepts Statement No. 3 (preceding items 2–3) is referred to in this guide when describing GASB requirements as *"GASB defined" SI*. GASB Concepts Statement No. 3 limits its discussion of supporting information to "GASB defined" SI and RSI.

In contrast, the AICPA auditing standards refer to such supporting information as either RSI, other information (OI), or SI. AU-C section 730, *Required Supplementary Information* (AICPA, *Professional Standards*), defines RSI consistently with GASB literature. Therefore, references to such information in this guide are to RSI. AU-C section 720, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*), defines *OI* as financial and nonfinancial information (other than the financial statements and the auditor's report thereon) that is included in a document containing audited financial statements and the auditor's report thereon, excluding RSI. AU-C section 725, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*), defines *SI* as information presented outside the basic financial statements, excluding RSI that is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. This guide uses SI to describe information for which (1) the required conditions in AU-C section 725 have been met and (2) the auditor has been engaged to provide an "in relation to" opinion and OI for situations when the limited procedures in AU-C section 720 are required.

Introduction

4.01 AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*), addresses the independent auditor's overall responsibilities when conducting an audit of financial statements in accordance with generally accepted auditing standards (GAAS). Specifically, it sets out the overall objectives of the independent auditor (the auditor) and explains the nature and scope of an audit designed to enable the auditor to meet those objectives. It also explains the scope, authority, and structure of GAAS and includes requirements establishing the general responsibilities of the auditor applicable in all audits, including the obligation to comply with GAAS.

4.02 Paragraph .12 of AU-C section 200 states that the overall objectives of the auditor, in conducting an audit of financial statements, are to

a. obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are presented fairly, in all material respects, in accordance with an applicable financial reporting framework; and

b. report on the financial statements, and communicate as required by GAAS, in accordance with the auditor's findings.

To obtain reasonable assurance, the auditor should obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion. The presentation of topics in this chapter aligns with the order of the applicable AU-C sections. The primary focus of the chapter is the auditor's assessment of risk and the response to that risk in audits of governmental entities.

General Principles and Responsibilities

Overall Objectives

4.03 AU-C section 200 defines audit risk as the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risk of material misstatement and detection risk. The auditor should design and implement overall responses to address the assessed risks of material misstatement at the financial statement level and should design and perform further audit procedures whose nature, timing, and extent are based on, and are responsive to, the assessed risks of material misstatement at the relevant assertion level. As explained in paragraph .A44 of AU-C section 200, the risks of material misstatement may be expressed in quantitative terms, such as percentages, or in nonquantitative terms (for example, high, medium, or low). In the context of a governmental audit, the overall financial statement level is at the level of the opinion units, as discussed in paragraphs 4.73–.77.

Terms of Engagement

4.04 For effective audits, communicating with the auditee is an ongoing process, beginning during audit planning and continuing through the delivery of the reports and, possibly, even after report delivery.

4.05 AU-C section 210, *Terms of Engagement* (AICPA, *Professional Standards*), requires the auditor to determine if preconditions for an audit are present. Preconditions for an audit include, among other things, the use by management of an acceptable financial reporting framework in the preparation and presentation of the financial statements. The acceptable reporting framework for state and local governments is either generally accepted accounting principles (GAAP) or a special-purpose framework as discussed in chapter 17, "Financial Statements Prepared in Accordance With a Special-Purpose Framework." The determination of whether an entity is governmental, and therefore subject to GAAP for state and local governments, is fundamental to the precondition of determining whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable. Governmental entities are subject to GAAP for state and local governments if they meet the definition of a government according to paragraph 1.01.

4.06 AU-C section 210 also requires the auditor to agree upon the terms of the audit engagement with management or those charged with governance, as appropriate, of the governmental entity regarding the services to be performed for each engagement. The agreed-upon terms of the audit engagement should be documented in a written engagement letter or other suitable form of written agreement. The specific elements the auditor should include in the engagement letter are discussed in paragraph .10 of AU-C section 210. In addition to the required elements, the auditor also may want to include in the engagement letter or contract, requirements for access to audit documentation and for communicating internal control related matters as well as topics described in paragraph 4.40 that are also applicable to the pre-audit conference.

4.07 When the auditor of the primary government is also the auditor of a component unit, the factors that may influence the decision whether to obtain a separate audit engagement letter from the component unit include the following:

- Who engages the component unit auditor
- Whether a separate auditor's report is to be issued on the component unit
- Legal requirements regarding the appointment of the auditor
- Degree of independence of the component management from the primary government

4.08 AU-C section 230, *Audit Documentation* (AICPA, *Professional Standards*), describes the auditor's responsibility to prepare audit documentation for an audit of financial statements. Interpretation No. 1, "Providing Access to or Copies of Audit Documentation to a Regulator," of AU-C section 230 (AICPA, *Professional Standards*, AU-C sec. 9230 par. .01–.15), provides guidance on responding to requests by governmental agencies (regulators) that auditors provide them with access to audit documentation. Auditors might consider discussing this requirement with the auditee or including it in the engagement letter. See chapter 15, "Concluding the Audit," for further discussion of audit documentation requirements.

Laws and Regulations[1, 2]

4.09 AU-C section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* (AICPA, *Professional Standards*), describes the auditor's responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatements arising from noncompliance with provisions of laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements. It also describes the auditor's responsibility regarding the provisions of laws and regulations that do not have a direct effect on the determination of material amounts and disclosures in the financial statements but compliance with which may be fundamental to the operating aspects of the business, fundamental to an entity's ability to continue its business, or necessary for the entity to avoid material penalties.

4.10 Paragraph .11 of AU-C section 250 defines *noncompliance* as acts of omission or commission by the entity, either intentional or unintentional, which are contrary to the prevailing laws or regulations. Such acts include transactions entered into by, or in the name of, the entity or on its behalf by those charged with governance, management or employees. Noncompliance does not include personal misconduct (unrelated to the business activities of the entity) by those charged with governance, management, or employees of the entity.

Responsibility of Management

4.11 In accordance with paragraph .03 of AU-C section 250, it is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity's financial statements. That responsibility encompasses identifying applicable compliance requirements and establishing internal controls designed to provide reasonable assurance that the entity complies with them. Governments are established by and operate under numerous laws and regulations, and they generally are subject to many more legal constraints than are nongovernmental entities. National Council on Governmental Accounting (NCGA) Statement 1, *Governmental Accounting and Financial Reporting Principles*, paragraph 5, recognizes that compliance requirements may affect governmental financial statements:

> An important aspect of GAAP as applied to governments is the recognition of the variety of legal and contractual considerations typical of the government environment. These considerations underlie and are

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[1] *Government Auditing Standards* states that, when performing an audit in accordance with *Government Auditing Standards*, auditors should extend the AICPA requirements pertaining to the auditor's responsibilities for laws and regulations to also apply to consideration of compliance with provisions of contracts and grant agreements. Further, *Government Auditing Standards* include additional guidance related to abuse, a concept that is not addressed in generally accepted auditing standards (GAAS). *Abuse* is defined as 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. Abuse also includes misuse of authority or position for personal financial interests or those of an immediate or close family member or business associate. See the AICPA Audit Guide Government Auditing Standards *and Single Audits*.

[2] AU-C section 935, *Compliance Audits* (AICPA, *Professional Standards*), provides requirements and guidance when the auditor is engaged to perform a compliance audit on compliance with certain laws certain and regulations.

reflected in the fund structure, bases of accounting, and other principles and methods set forth here, and are a major factor distinguishing governmental accounting from commercial accounting.

4.12 The following categories of compliance requirements may have a direct effect on the determination of material financial statement amounts and disclosures (as described in paragraph .06*a* of AU-C section 250) or noncompliance with the requirements that may materially affect the financial statements (as described in paragraph .06*b* of AU-C section 250). To understand these and other compliance matters within the scope of the audit, the auditor may consider seeking guidance from auditee officials, officials of other levels of government with oversight responsibility, and legal counsel:

- *GAAP requirements*. Governments often are subject to legal or contractual provisions that require them to prepare their financial statements in accordance with GAAP.
- *Federal and state taxes.* Governments are subject to various federal tax requirements, including those relating to employment taxes, employee benefits, and tax-exempt debt (such as arbitrage rebate requirements). State-level tax requirements also may apply.
- *Legal authority for transactions*. Governments often have legal authority to execute transactions. That is, governments, especially local governments, often cannot exercise powers or conduct activities unless authorized by law. For example, a local government may not be able to levy property taxes unless specifically authorized to do so under state law and taxes levied without proper authority may be subject to refund.
- *Establishment of funds*. As discussed in chapter 2, "Financial Reporting," legal and contractual provisions may require governments to establish individual funds to account for and report on particular activities.
- *Time and other eligibility requirements and purpose restrictions on nonexchange transactions*. Time and other eligibility requirements and purpose restrictions affect the recognition and reporting of nonexchange transactions. A government's failure to comply with a provider's eligibility requirements and purpose restrictions may cause the provider to withdraw the intended support or request a refund of amounts previously paid. For example, if a government expends federal funds for purposes that are considered unallowable under federal regulation, the federal government may reduce future federal funding or request that the funds be returned. Similarly, legal provisions may restrict a government's use of its tax revenues (such as a constitutional requirement that the proceeds of a state gasoline tax be expended only for the maintenance of highways).
- *Other legal- and contract-based compliance requirements*. Besides the eligibility requirements and purpose restrictions that affect the recognition and reporting of nonexchange transactions, providers of such resources may impose other compliance requirements on recipients. For example, federal financial assistance programs often require recipients to adhere to specific procurement and cash management policies. There also may be contractual

compliance requirements relating to exchange transactions, such as debt issuances.

- *Budgets and appropriation laws*. Budgets and appropriations often establish the particular funds that can finance particular costs and the nature and amount of interfund activity. Additionally, budgets and appropriations may establish spending limits which may not be exceeded without additional action by the governing body.
- *Tax and debt limitations*. Governments often are subject to legal provisions that limit taxing authority, impose ceilings and other issuance requirements on debt, or limit the use of debt proceeds to particular purposes. For example, state law may impose a millage cap on property taxes or require tax refunds if an entity's annual revenue growth exceeds a set percentage or amount. Also, debt often is issued subject to contractual provisions that require certain reserve fund and revenue coverage amounts.
- *Cash and investments*. Governments often have legally limited choices for depositing and investing available cash resources. For example, investments in derivative instruments, hedge funds, and debt instruments with long maturities might be prohibited.
- *Expenditure and contracting limitations*. Governments might be prohibited from purchasing certain products or services without open competitive bidding or following other purchasing procedures established by laws and regulations.

The compliance requirements listed previously may not materially affect financial statement amounts and disclosures of all governmental entities. Further, there may be categories of compliance requirements other than those included here for which noncompliance could materially affect financial statement amounts and disclosures as discussed in paragraphs 4.15–.18.

4.13 In addition, GASB standards require governments to disclose certain violations of compliance requirements. NCGA Interpretation 6, *Notes to the Financial Statements Disclosure*, paragraph 4, states that the notes to the financial statements should disclose material violations of finance-related legal and contractual provisions.[3] GASB standards expand on that requirement by requiring disclosure concerning noncompliance with specific finance-related legal and contractual provisions. For example, GASB Statement No. 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements*, paragraph 66, requires governments to disclose significant violations during the reporting period of legal or contractual provisions for deposits and investments. In addition, GASB Statement No. 38, *Certain Financial Statement Note Disclosures*, requires disclosure of actions taken to address significant violations of finance-related legal or contractual provisions. The auditor should also evaluate the adequacy of the government's disclosures about noncompliance with laws and regulations within the context of the auditor's responsibilities established in AU-C section 250.

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[3] In addition, material violation, or potential violations of finance-related legal and contractual provisions should be considered for recording a loss contingency. Chapter 8, "Expenses or Expenditures and Liabilities," discusses loss contingencies.

Responsibility of the Auditor

4.14 Because GAAP require governments to disclose material violations of finance-related legal and contractual provisions (see paragraph 4.13), the auditor of a governmental entity should be alert to the possible financial reporting effect of noncompliance that materially affects the financial statements and disclosures. However, even though a violation of such a compliance requirement can have consequences that are material to the financial statements, the auditor may not become aware of the violation unless informed of it by the entity or there is evidence of the violation in the documents the auditor normally inspects during the audit.

4.15 According to AU-C section 250, the auditor is responsible for obtaining reasonable assurance that the financial statements as a whole are free from material misstatement, whether caused by fraud or error. In the context of a governmental audit, the overall financial statement level would be at the level of the opinion units as discussed in paragraphs 4.73–.77. In conducting an audit of financial statements, the auditor takes into account the applicable legal and regulatory framework. Because of the inherent limitations of an audit, an unavoidable risk exists that some material misstatements in the financial statements may not be detected, even though the audit is properly planned and performed in accordance with GAAS. In the context of laws and regulations, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for the following reasons:

- Many laws and regulations relating principally to the operating aspects of an entity typically do not affect the financial statements and are not captured by the entity's information systems relevant to financial reporting.
- Noncompliance may involve conduct designed to conceal it, such as collusion, forgery, deliberate failure to record transactions, management override of controls, or intentional misrepresentations made to the auditor.
- Whether an act constitutes noncompliance is ultimately a matter for legal determination, such as by a court of law.

Ordinarily, the further removed noncompliance is from the events and transactions reflected in the financial statements, the less likely the auditor is to become aware of, or recognize, the noncompliance.

4.16 Paragraph .06 of AU-C section 250 distinguishes the auditor's responsibilities regarding compliance with the following two categories of laws and regulations:

a. The provisions of those laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements, such as tax and pension laws and regulations

b. The provisions of other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements but compliance with which may be

   i. fundamental to the operating aspects of the business,

   ii. fundamental to an entity's ability to continue its business, or

   iii. necessary for the entity to avoid material penalties.

Examples are discussed in paragraph 4.12 and include matters for which noncompliance may have a material effect on the financial statements.

4.17 Differing requirements are specified for each of the previously mentioned categories of laws and regulations and are set forth in paragraph .07 of AU-C section 250. For the category referred to in paragraph 4.16*a*, the auditor's responsibility is to obtain sufficient appropriate audit evidence regarding material amounts and disclosures in the financial statements that are determined by the provisions of those laws and regulations. For the category referred to in paragraph 4.16*b*, the auditor's responsibility is limited to performing specified audit procedures that may identify noncompliance with those laws and regulations that may have a material effect on the financial statements.

4.18 As required in paragraph .14 of AU-C section 250, the auditor should perform the following audit procedures that may identify instances of noncompliance with other laws and regulations described in paragraph 4.16*b* that may have a material effect on the financial statements:

a. Inquiring of management and, when appropriate, those charged with governance about whether the entity is in compliance with such laws and regulations

b. Inspecting correspondence, if any, with the relevant licensing or regulatory authorities

4.19 The auditor is required by paragraph .08 of AU-C section 250 to remain alert to the possibility that other audit procedures applied for the purpose of forming an opinion on financial statements may bring instances of identified or suspected noncompliance with laws and regulations to the auditor's attention. Maintaining professional skepticism throughout the audit, as required by AU-C section 200, is important in this context, given the extent of laws and regulations that affect the entity.

4.20 In considering whether the financial statements are free from material misstatements arising from violations of compliance requirements that materially affect the financial statement amounts and disclosures, the auditor should consider both quantitative and qualitative factors. Qualitative factors that the auditor may consider relevant to that evaluation include the following:

- The potential effect of the noncompliance on the government's ability to raise resources (for example, through taxes, grants, contributions, or debt or loan financings) in the future
- The potential effect of the noncompliance on the continuation of existing relationships with vendors, employees, and elected and appointed officials
- Whether the noncompliance involves collusion or concealment
- Whether the noncompliance involves an activity that often is scrutinized by elected or appointed officials, citizens, the press, creditors, or rating agencies
- Whether the fact of the noncompliance is unambiguous rather than a matter of judgment
- Whether the noncompliance is an isolated event or instead has occurred with some frequency
- Whether the noncompliance results from management's continued unwillingness to correct internal control weaknesses

- The likelihood that similar noncompliance will continue in the future
- The risk that possible undetected noncompliance would affect the auditor's evaluation

4.21 The auditor may consider performing the following procedures to assess management's identification of compliance requirements that could materially affect financial statement amounts and disclosures:

- Consider knowledge about compliance requirements obtained during prior-period audits.
- Interview the entity's chief financial officer, legal counsel, internal auditor, or grant administrators about compliance requirements.
- Identify sources of revenue, review any related agreements (for example, loan, grant, and contribution agreements), and ask about legal provisions and enabling legislation that relate to using and accounting for the revenue.
- Obtain and review federal and state publications pertaining to compliance requirements, such as Department of the Treasury and Internal Revenue Service regulations (concerning the calculation and reporting of arbitrage rebates and refunds and employment taxes), OMB's cost principles and administrative requirements circulars or the Title 2 U.S. *Code of Federal Regulations* Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance) cost principles and administrative requirements, as applicable to the award, and the OMB *Compliance Supplement*, the *Catalog of Federal Domestic Assistance*, and similar state program publications (concerning grants and appropriations).
- Obtain and review sections of the state constitution, statutes, and regulations that pertain to the entity, in particular the sections that concern financial reporting, investment, debt, taxation, budget, appropriation, and procurement matters.
- Review the minutes of meetings of the entity's governing board for the enactment of relevant laws and regulations and information about relevant contracts and grant agreements.
- Ask federal, state, or local auditors or other appropriate audit oversight organizations about applicable compliance requirements, including statutes and uniform reporting requirements.
- Ask the audit, finance, or program administrators of other entities from which the entity receives grants, contributions, and appropriations about the restrictions, limitations, terms, and conditions under which the amounts were provided.
- Review the discussions of compliance requirements applicable to specific industries, as found in this guide and other relevant AICPA Audit and Accounting Guides (see chapter 1, "Overview and Introduction").
- Review accounting and auditing materials available from other professional organizations, such as state societies of certified public accountants and governmental associations.

To obtain information about possible violations of compliance requirements, the auditor should consider making inquiries of management, legal counsel, internal auditors, grant administrators, and other appropriate sources; and testing transactions for adherence with compliance requirements.

4.22 Paragraphs .A43–.A46 of AU-C section 240, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*), and paragraphs .17–.20 of AU-C section 250 describe the situations in which an auditor should extend procedures when the auditor has determined that a misstatement is, or may be, the result of fraud or when noncompliance is identified or suspected, respectively. (Appendix A to this chapter discusses the provisions of AU-C section 240.)

Auditor's Communication With Those Charged With Governance[4]

4.23 AU-C section 260, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*), addresses responsibilities of the auditor to communicate with those charged with governance in an audit of financial statements. The term *those charged with governance* is defined in paragraph .14 of AU-C section 200, as "the person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process." In most governmental entities, governance is a collective responsibility that may be carried out by a legislative body, such as a city council or a school district board of education; a committee of the legislative body (for example, an audit or legislative oversight committee); elected and appointed officials, such as a mayor or school superintendent; a committee of management (for example, a finance, budget, or governmental agency executive committee); equivalent persons; or some combination of these parties. Because the governance structures of government entities and organizations receiving government funding can vary widely, it may not always be clearly evident who is charged with key governance functions. In these situations, auditors evaluate the organizational structure for directing and controlling operations to achieve the auditee's objectives. This evaluation also includes how the auditee delegates authority and establishes accountability for its management personnel. In situations in which the appropriate person(s) is not clearly identifiable, the auditor and engaging party may need to discuss and agree on the relevant person(s) within the governance structure with whom the auditor will communicate.

4.24 The requirements of AU-C section 260 apply regardless of a governmental entity's governance structure or size. Matters to be communicated include

- The auditor's responsibilities with regard to the financial statement audit
- The planned scope and timing of the audit
- Significant findings or issues from the audit

4.25 The communication of the planned scope and timing of the audit includes the specific auditor's reports to be issued. For example, in an audit conducted in accordance with GAAS, the auditor may be required to report on any or all of the following:

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[4] In addition to the requirements of GAAS, *Government Auditing Standards* includes an additional requirement related to auditor communication. See the AICPA Audit Guide Government Auditing Standards *and Single Audits*.

- The basic financial statements with accompanying RSI, as discussed in chapter 2. The basic financial statements are the minimum financial statements that should be prepared under GAAP and, generally contain government-wide financial statements, fund financial statements, and notes to the financial statements. RSI consists of management's discussion and analysis (MD&A) and, when applicable, other RSI.[5]
- The comprehensive annual financial report (CAFR), which, in addition to the basic financial statements with accompanying RSI, contains the following:[6]
  - — An introductory section
  - — Appropriate combining and individual fund financial statements and schedules
  - — A statistical section
- The financial statements of the primary government or of a component unit, department, agency, program, or individual fund.

4.26 See chapter 15 for further discussion of AU-C section 260. Additionally, paragraphs 4.128–.137 discuss the auditor's responsibility for performing procedures on RSI, OI, and SI. Chapter 16, "Audit Reporting," discusses and illustrates the auditor's reporting on governmental financial statements.

4.27 A communication with those charged with governance may be necessary when the auditor becomes aware that the entity is subject to an audit requirement that is not encompassed in the terms of the engagement. The communication would be appropriate when the auditor finds that an audit conducted in accordance with GAAS may not satisfy the relevant legal, regulatory, or contractual requirements, for example, when an entity engages an auditor to perform an audit of its financial statements in accordance with GAAS and the auditor becomes aware the entity also is required to have an audit performed in accordance with one or more of the following:

a. *Government Auditing Standards*

b. The Uniform Guidance

c. Other compliance audit requirements, such as state or local laws or program-specific audits under federal audit guides.

Communicating Internal Control Related Matters

4.28 AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*), addresses the auditor's responsibility to appropriately communicate to those charged with governance and management deficiencies in internal control that the auditor has identified in an audit of the financial statements.

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[5] As discussed in chapter 2, "Financial Reporting," and chapter 11, "The Budget," GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, as amended, permits governments to elect to report certain required budgetary comparison information in a budgetary comparison statement as part of the basic financial statements, rather than as required supplementary information (RSI).

[6] This accompanying material is "GASB defined" supplementary information. This chapter and chapter 16, "Audit Reporting," discuss the auditor's responsibility for and reporting on other information (OI) as well as situations when the auditor is engaged to issue an "in relation to" opinion on supplementary information (SI), such as the combining and individual fund financial statements.

4.29 In addition to requiring written communication of a description of significant deficiencies and material weaknesses and an explanation of their potential effects in the internal control over financial reporting, AU-C section 265 states that for some matters early communication to management or those charged with governance may be important because of the relative significance of the deficiency and the urgency for corrective follow-up action. Therefore, the auditor may choose to communicate significant matters related to internal control over financial reporting during the course of the audit rather than after the audit is concluded. The auditor is also required to communicate to management, in writing or orally, other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit management's attention. See the AICPA Audit Guide Government Auditing Standards *and Single Audits* for additional discussion of internal control reporting requirements in an audit performed under *Government Auditing Standards* and the Uniform Guidance.

Auditor's Risk Assessment and Response to Assessed Audit Risk

Planning an Audit

4.30 This section addresses procedures for planning the audit of the financial statements of a governmental entity under GAAS. The AICPA Audit Guide Government Auditing Standards *and Single Audits* discusses planning procedures for audits that also are conducted in accordance with the provisions of (*a*) *Government Auditing Standards* (also referred to as the Yellow Book), issued by the Comptroller General of the United States and (*b*) the Single Audit Act Amendments of 1996 and the Uniform Guidance.[7]

4.31 GASB establishes accounting and financial reporting standards for state and local governments. Chapter 2 discusses governmental financial statements and certain auditing considerations relating to them. Chapter 3, "The Financial Reporting Entity," and chapters 5–10 discuss the audit objectives, internal control features, and audit procedures that may be considered in developing audit programs for financial statement components and elements. In planning the audit, the auditor uses auditing standards and interpretive publications, including this guide, to meet the objectives of each specific audit engagement.

4.32 AU-C section 300, *Planning an Audit* (AICPA, *Professional Standards*), addresses the auditor's responsibilities to plan an audit of financial statements and is written in the context of recurring audits. Additional considerations for initial audit engagements are addressed in AU-C section 510, *Opening Balances—Initial Audit Engagements, Including Reaudit Engagements* (AICPA *Professional Standards*). Matters related to planning audits of group financial statements are discussed in this chapter beginning at paragraph 4.95.

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[7] AU-C section 935 is applicable when an auditor is engaged, or required by law or regulation, to perform a compliance audit in accordance with (*a*) GAAS, (*b*) standards for financial audits under *Government Auditing Standards*, and (*c*) a governmental audit requirement that requires an auditor to express an opinion on compliance. AU-C section 935 does not apply to the financial statement audit that may be performed in conjunction with a compliance audit. See the AICPA Audit Guide Government Auditing Standards *and Single Audits* for more information.

4.33 Planning activities include performing preliminary engagement activities; establishing and documenting an overall audit strategy; communicating with those charged with governance an overview of the planned scope and timing of the audit; developing a detailed written audit plan; and determining the extent of involvement of professionals with specialized skills. The nature, timing, and extent of direction and supervision of engagement team members depends on many factors including, the size and complexity of the entity, areas of the audit, assessed risks of material misstatement, and capabilities and competence of individual team members. Planning is not a discrete phase of an audit but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. Any significant changes to the overall audit strategy or the audit plan should be documented, including the reasons for such changes.

4.34 The auditor might consider holding a preaudit conference with the auditee to discuss the responsibilities of both the auditee and the auditor. The understandings reached during the preaudit conference may be documented as provided for in AU-C section 230. Topics for the preaudit conference with elements that are unique to or significant in a governmental audit could include the following:[8]

- Identification of audit staff who have knowledge and experience with governmental accounting, financial reporting, and audits[9]
- The use of other auditors and the effect of those other auditors on the timing of the audit and on the auditor's report (see paragraphs 4.95–.122)
- The effect of the use of service organizations (see paragraph 4.56) and auditor's or management's specialists on audit procedures
- Audit timing, including dates for the following:
    - — Availability of records, especially when a government's accounting records are decentralized among several departments or other accountability centers
    - — The required delivery of the report, which may be affected by legal and contractual provisions
- New accounting and financial reporting standards that the entity has or is required to implement (see paragraph 4.50)
- Reports to be provided by the auditor pursuant to the terms of engagement (see paragraph 4.25)
- Applicable audit requirements, including those in addition to an audit in accordance with GAAS (see paragraph 4.27)

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[8] Discussion at the preaudit conference may be influenced by materiality determinations for financial statement preparation and audit purposes as discussed in paragraphs 4.67–.87.

[9] *Government Auditing Standards* establishes a general standard regarding competence. As part of that standard, an audit organization should have a process for recruiting, hiring, continuously developing, assigning, and evaluating staff to assist the organization in maintaining a workforce that has adequate competence. One of the areas that process should address is continuing professional education (CPE). *Government Auditing Standards* requires CPE for audit personnel in subjects that directly enhance their professional proficiency to perform audits or attestation engagements and that relate to the specific or unique environment in which the auditee operates. See the AICPA Audit Guide Government Auditing Standards *and Single Audits*.

- The effect of new auditing requirements on audit procedures or the scope of the audit
- The auditor's responsibilities for
  - — discovering and reporting material misstatements resulting from noncompliance with laws and regulations, errors, or fraud (see paragraphs 4.09–.22)
  - — making specific inquiries of those charged with governance, internal auditors, and other entity personnel about fraud (Appendix A to this chapter discusses the provisions of AU-C section 240.)
  - — communicating certain matters to those charged with governance, including information about uncorrected misstatements aggregated by the auditor that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements for the opinion units in the government's financial statements (see the discussion of materiality determinations and opinion units in a governmental audit in paragraphs 4.67–.87 and the discussions about communications with the audit committee in paragraph 4.28 and chapter 15)
- The auditee's responsibilities for
  - — providing access to all information that is relevant to the preparation and fair presentation of the financial statements; any additional information requested from management for the purpose of the audit; and unrestricted access to persons within the entity from whom the auditor evaluates whether it may be necessary to obtain evidence
  - — preparing worksheets, schedules, and other "prepared by client" material needed for the audit
  - — preparing the basic financial statements, RSI, including MD&A, and supplementary information other than RSI (referred to in this guide as "GASB defined" SI)
  - — determining whether required budgetary compliance information will be presented in the basic financial statements or as RSI
  - — identifying all component units that should be reported in the reporting entity's financial statements and determining how they should be displayed
  - — identifying compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in the financial statement and for disclosing applicable instances of noncompliance (see paragraphs 4.09 and 4.12–.14)
  - — adjusting the financial statements to correct material misstatements and for affirming to the auditor in the representation letter that the effects of any uncorrected misstatements aggregated by the auditor are immaterial, both individually and in the aggregate, to the financial

statements for the opinion units in the government's financial statements (see the discussion of materiality determinations and opinion units in a governmental audit in paragraphs 4.67–.87)

- — identifying related-party transactions and for determining the appropriate reporting (see paragraph 4.94)
- — complying with any industry association certificate program requirements (if applicable) for the CAFR
- — signing a management representation letter that may include government-specific representations (see chapter 15)

- The need for lawyer letters or for alternative procedures if the government does not retain inside or outside counsel and has not consulted a lawyer during the period about litigation, claims, or assessments (see chapter 15)
- Internal audit assistance the auditor expects to receive from the auditee (see paragraphs 4.65–.66)

Audit Strategy

4.35 As stated in paragraph .09 of AU-C section 300, the auditor should develop an audit plan that includes a description of (*a*) the nature and extent of planned risk assessment procedures as determined under AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*); (*b*) the nature, timing, and extent of planned further audit procedures at the relevant assertion level, as determined under AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*); and (*c*) other planned audit procedures that are required to be carried out so that the engagement complies with GAAS. The appendix, "Considerations in Establishing the Overall Audit Strategy," of AU-C section 300, provides useful examples of matters the auditor may consider in establishing the overall audit strategy, many of which will also influence the auditor's detailed audit plan. Because government-wide and fund financial statements often include various opinion units, audit tests are most efficient if they are designed to avoid repetitive procedures. However, if the government operates one or more activities separately or autonomously, the auditor may need to perform procedures on those activities separately.

4.36 Many auditors plan and perform audit work based upon an entity's classes of transactions. For example, an auditor may plan and perform audit procedures relating to an entity's revenue and receivables by examining the cash receipts cycle. While planning the audit procedures associated with a class of transactions, the auditor should ensure that appropriate coverage is given to each opinion unit in light of the applicable risk of material misstatement (see the discussion of materiality determinations and opinion units in paragraphs 4.67–.87). If a government's internal control for a class of transactions is handled by the same system regardless of where the transactions and balances are reported in the financial statements, the auditor's consideration of internal control and assessment of control risk for that system would apply equally to all affected opinion units, even if transactions and balances reported in an individual opinion unit are not included in a test of controls. However, in designing substantive tests of financial statement assertions, the auditor should use professional judgment in designing audit procedures that will provide appropriate substantive evidence for the auditor's separate opinion on each opinion unit.

4.37 Many governments maintain their primary accounting records based on funds and typically use a separate process through which they separately develop the additional information needed for the government-wide financial statements. According to paragraph .03 of AU-C section 315, the objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and relevant assertion levels through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement. Paragraph .30 of AU-C section 315 states that for significant risks, the auditor should obtain an understanding of the entity's controls, including control activities, relevant to that risk and, based on that understanding, evaluate whether such controls have been suitably designed and implemented to mitigate such risks. Further, the auditor may find it efficient to plan and perform the audit by considering the fund financial statements first and then the additional information developed for the government-wide financial statements. Although much of that additional information is displayed in the reconciliations between the fund financial statements and the government-wide financial statements (such as capital asset and long-term debt information and asset and liability accruals), some additional information is not displayed in the reconciliations (such as the eliminations and reclassifications of internal activity and classifications of program and general revenues). In planning and performing the audit in this manner, the auditor should obtain a sufficient understanding of the different processes and internal control over the additional information developed for the government-wide financial statements. The auditor's responsibility for considering the processes and internal control over the additional information developed for the government-wide financial statements is the same as the auditor's responsibility for considering the processes and internal control over the fund financial statements.

4.38 In considering audit risk at the overall financial statement level, the auditor should consider risks of material misstatement that relate pervasively to the financial statements as a whole. As discussed in paragraph 4.67, in a governmental audit, "as a whole" means considering each "opinion unit" separately. Risks of a pervasive nature often relate to the entity's control environment and are not necessarily identifiable with specific relevant assertions at the class of transactions, account balance, disclosure level, or opinion unit. Such risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud, for example, through management override of internal control.

Use of Assertions in Obtaining Audit Evidence

4.39 Paragraphs .A113–.A118 of AU-C section 315 discuss the use of assertions in the assessment of risks of material misstatement. In representing that the financial statements are presented in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation, and disclosure of the various elements of the financial statements and related disclosures. Assertions used by the auditor to consider different types of potential misstatements fall into the following categories and may take many forms:

Categories of Assertions

	Description of Assertions		
	Classes of Transactions and Events During the Period	*Account Balances at the End of the Period*	*Presentation and Disclosure*
Occurrence/ Existence	Transactions and events that have been recorded have occurred and pertain to the entity.	Assets, deferred outflows of resources, liabilities, and deferred inflows of resources exist.	Disclosed events and transactions have occurred.
Rights and Obligations	—	The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.	Disclosed events and transactions pertain to the entity.
Completeness	All transactions and events that should have been recorded have been recorded.	All assets, deferred outflows of resources, liabilities, and deferred inflows of resources that should have been recorded have been recorded.	All disclosures that should have been included in the financial statements have been included.
Accuracy/ Valuation and Allocation	Amounts and other data relating to recorded transactions and events have been recorded appropriately.	Assets, deferred outflows of resources, liabilities, deferred inflows of resources, fund balances, and net position are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are recorded appropriately.	Financial and other information is disclosed fairly and at appropriate amounts.

(continued)

Categories of Assertions—*continued*

	Description of Assertions		
	Classes of Transactions and Events During the Period	*Account Balances at the End of the Period*	*Presentation and Disclosure*
Cut-off	Transactions and events have been recorded in the correct accounting period.	—	—
Classification and Understandability	Transactions and events have been recorded in the proper accounts.	Classifications between current and noncurrent assets and liabilities of proprietary funds and classifications of net positions and fund balances are properly presented.	Financial information is appropriately presented and described, and information in disclosures is expressed clearly.

4.40 The auditor should use relevant assertions for classes of transactions, account balances, and presentation and disclosures in sufficient detail to form a basis for the assessment of risks of material misstatement and the design and performance of further audit procedures. The auditor should use relevant assertions in assessing risks by considering the different types of potential misstatements that may occur, and then designing further audit procedures that are responsive to the assessed risks.

Understanding the Entity, Its Environment, and Its Internal Control

4.41 AU-C section 315 establishes standards and provides guidance about the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements through understanding the entity and its environment, including the entity's internal control.

4.42 Obtaining an understanding of the entity and its environment, including its internal control, is a continuous, dynamic process of gathering, updating, and analyzing information throughout the audit. The understanding of the entity establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit when, for example

- assessing risks of material misstatement of the financial statements;
- determining materiality in accordance with AU-C section 320, *Materiality in Planning and Performing an Audit* (AICPA, *Professional Standards*);

- considering the appropriateness of the selection and application of accounting policies and the adequacy of financial statement disclosures;
- identifying areas for which special audit consideration may be necessary (for example, related party transactions, the appropriateness of management's use of the going concern assumption, considering the business purpose of transactions, or the existence of complex and unusual transactions);
- developing expectations for use when performing analytical procedures;
- responding to the assessed risks of material misstatement, including designing and performing further audit procedures to obtain sufficient appropriate audit evidence; and
- evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and management's oral and written representations.

Risk Assessment Procedures and Related Activities

4.43 As described in paragraph .05 of AU-C section 315, the auditor should perform *risk assessment procedures* to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and relevant assertion levels. For purposes of GAAS, risk assessment procedures are defined in AU-C section 315 as audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and relevant assertion levels. Risk assessment procedures by themselves; however, do not provide sufficient appropriate audit evidence on which to base the audit opinion. Risk assessment procedures include the following:

a. Inquiries of management and others within the entity who, in the auditor's professional judgment, may have information that is likely to assist in identifying risks of material misstatement due to fraud or error

b. Analytical procedures

c. Observation and inspection

Analytical Procedures as Risk Assessment Procedures

4.44 Paragraphs .A7–.A10 of AU-C section 315 provide additional explanation for analytical procedures performed during the risk assessment process.[10] Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. Analytical procedures may enhance the auditor's understanding of the entity's business and the significant transactions and events that have occurred since the prior audit and help to identify the existence of unusual transactions or events and amounts, ratios, and trends that might indicate matters that have audit implications.

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[10] The AICPA Audit Guide *Analytical Procedures* provides practical guidance to auditors on the effective use of analytical procedures.

4.45 Analytical procedures performed as risk assessment procedures may include both financial and nonfinancial information. In the context of a governmental audit, the auditor should apply these analytical procedures at the opinion unit level. As one example of an analytical procedure used as a risk assessment procedure, the auditor could compare a government's actual results to its budgets, even if the budgets are not legally required or the budgetary comparison information is not presented as a basic financial statement, if the budgets otherwise are realistic. (See the discussion of opinion units at paragraphs 4.73–.77.)

Discussion Among the Audit Team

4.46 In performing risk assessment procedures in accordance with paragraph .11 of AU-C section 315, the engagement partner and other key engagement team members should discuss the susceptibility of the entity's financial statements to material misstatement and the application of the applicable financial reporting framework to the entity's facts and circumstances. The engagement partner should determine which matters are to be communicated to engagement team members not involved in the discussion. Paragraph .A14 of AU-C section 315 states this discussion may be held concurrently with the discussion among the engagement team that is required by AU-C section 240 to discuss the susceptibility of the entity's financial statements to fraud. Additionally, paragraph .12 of AU-C section 300 requires that consideration be given on whether or not to include specialists assigned to the audit team. For example, the auditor may determine that a professional possessing IT or other specialized skills is needed on the audit team and therefore include that individual in the discussion.

Auditor's Understanding of the Entity and Its Environment

4.47 The auditor's understanding of the entity and its environment consists of an understanding of the following aspects:

- *a.* Relevant industry (governmental), regulatory, and other external factors, including the applicable financial reporting framework
- *b.* Nature of the entity, including its operations, governance structures; the types of investments that the government is making and plans to make, including investment in entities formed to accomplish specific objectives and the way the government is structured and how it is financed.
- *c.* The government's selection and application of accounting policies, including the reasons for changes thereto. The auditor should evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry
- *d.* The government's objectives and strategies and the related business risks that may result in a material misstatement of an opinion unit
- *e.* The measurement and review of the entity's financial (generally budget and program) performance

Refer to appendix A, "Understanding the Entity and Its Environment," of AU-C section 315 which provides guidance on matters the auditor may consider when obtaining an understanding of the entity and its environment relating to categories *a–d*. Appendix B, "Internal Control Components," of AU-C section

315 contains a detailed explanation of internal control components. Matters to consider in obtaining an understanding of a governmental entity and its environment are discussed in the following section.

Understanding the Government

4.48 In a governmental audit, the auditor should also obtain an understanding of the operations of both the governmental industry and the entity to assess the risks of material misstatement and design further audit procedures. Information that may be useful in gaining this understanding generally can be obtained from, for example, federal and state laws and regulations, local charters, budget documents, recent official statements, prior-period financial reports, the request for proposal for audit services, minutes of meetings of the governing body and its committees and boards, and discussions with key members of management. Such information may include the following:[11]

- Economic, legislative, regulatory, accounting, and auditing developments that affect the governmental industry in general and the auditee in particular
- The composition of the reporting entity
- Relationships and operations between the reporting entity and its component units
- The form of government for the primary government and its component units, for example, a governing board with an elected governor or mayor as the administrator versus a governing board with an appointed manager
- Organizational structure, including the names and experience of top management
- The relationship between the governing body and the CEO and the relationship between the CEO and key management (that is, heads of agencies, departments, divisions, and so on)
- Federal, state, and local laws and regulations governing the general operations of the entity and its component units
- The nature of any joint ventures and the related underlying business rationale
- Factors affecting the continued functioning of the government, for example, the presence or absence of taxpayer initiatives that limit its budget growth or addition of services
- Budget philosophies (that is, are revenues budgeted conservatively and expenses/expenditures budgeted aggressively or the reverse) and how elected officials look to balance the budget in times of economic stress or decline
- Debt management policies and their underlying rationale
- Investment management policies and their underlying rationale
- The existence and functions of an audit committee or other group or individual with oversight responsibility for financial reporting

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[11] These examples represent typical and common aspects of state and local governments but do not comprise all aspects of the auditor's understanding of the entity and its environment.

- Primary sources of revenue (for example, property taxes, appropriations from other governments, grants, contracts, and service charges), how and at what location they are received by the entity (that is, customer remittances, mailed checks, electronic funds transfer, and so on), and how transactions are authorized, initiated, recorded, and reported
- Services provided by the entity and the relative level of resources used for each function or program
- Involvement in complex, unusual, or risky activities and the entity's rationale for entering into such arrangements
- Services and in-kind services provided by separate departments and independent entities (for example, hospitals, school districts, redevelopment agencies) and their relationship to the entity to be audited
- Accounting and financial reporting requirements established by another government with financial reporting oversight responsibilities
- Accounting and financial reporting policies, procedures, and systems, including the number and nature of funds, when funds are created or eliminated, supplementary records that are maintained for capital assets (including infrastructure capital assets) and long-term debt, and the entity's methods of producing information for presentation in the government-wide financial statements from fund-based accounting data
- If accounting and financial reporting functions are automated, the types of computer equipment used, personnel involved, and similar background information, including software packages and operating systems and how often each are reviewed for continued adequacy and relevance
- Opinion modifications on prior-period financial statements that could lead to opinion modifications on the current-period financial statements
- The current status of deficiencies in internal control previously communicated to those charged with governance and the reasons for any that have not been corrected
- Findings of any regulatory or oversight agency whether they be financial or operational in nature
- The current status of prior-period findings,[12] including findings and questioned costs in compliance audits that could require the reporting of contingent liabilities
- The nature of any compliance auditing requirements
- Special reporting requirements

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[12] For audits performed under *Government Auditing Standards*, paragraph 4.05 of *Government Auditing Standards, 2011 Revision* includes an additional requirement for auditors to evaluate whether the audited entity has taken appropriate corrective action to address findings and recommendations from previous engagements that could have a material effect on the financial statements or other financial data significant to the audit objectives. When planning the audit, auditors should ask management of the audited entity to identify previous audits, attestation engagements, and other studies that directly relate to the objectives of the audit, including whether related recommendations have been implemented. Auditors should use this information in assessing risk and determining the nature, timing, and extent of current audit work, including determining the extent to which testing the implementation of the corrective actions is applicable to the current audit objectives. Also, see the AICPA Audit Guide Government Auditing Standards *and Single Audits*.

4.49 Because of legal or contractual provisions concerning confidentiality, some governments restrict an auditor's access to certain source records that support amounts that are material to the financial statements. For example, state constitution or legislation may restrict access of state income tax returns to employees of the state's revenue collection department. In such a situation, an auditor may be able to perform adequate alternative procedures to obtain sufficient appropriate audit evidence to achieve the audit objectives. Alternatives may include procedures performed by the internal audit organization for the auditor or substantive procedures that provide indirect evidence about the information, such as analytical procedures. AU-C section 610, *Using the Work of Internal Auditors* (AICPA, *Professional Standards*),[13] provides requirements and guidance when using the work of internal auditors. AU-C section 520, *Analytical Procedures* (AICPA, *Professional Standards*), addresses the auditor's use of analytical procedures as substantive procedures. AU-C section 700, *Forming an Opinion and Reporting on Financial Statements* (AICPA, *Professional Standards*), provides requirements and guidance if the auditor is not able to perform adequate alternative procedures. As discussed in AU-C section 700, restrictions on the scope of the audit, whether imposed by the client or by circumstances, including the inability to obtain sufficient appropriate audit evidence, may require the auditor to qualify the opinion or to disclaim an opinion (see chapter 16).

Understanding Governmental Accounting and Financial Reporting Standards

4.50 Auditors should understand the unique nature of the governmental financial reporting model, as described in chapter 2. In auditing a government's financial statements, two financial reporting concerns may include evaluating which funds are separately reported as major funds and the presentation of comparative financial information, as discussed in chapters 2 and 16. Further, during planning, the auditor should consider whether the entity has or is required to implement new accounting and financial reporting standards.

Understanding of Internal Control

4.51 Paragraphs .13–.14 of AU-C section 315 states that the auditor should obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit. When obtaining an understanding of relevant controls, the auditor should evaluate the design of those controls and determine whether they have been implemented by performing procedures in addition to inquiry of the entity's personnel. An understanding of the five components of internal control (see paragraph 4.54) assists the auditor in identifying the types of potential misstatements and factors that affect the risks of material misstatement and in designing the nature, timing, and extent of further audit procedures. Because an audit of a government's financial statements is based on opinion units as discussed in paragraph 4.67, the auditor's consideration of internal control in assessing the risks of material misstatement should address each opinion unit. (See also paragraph 4.36.)

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[13] AU-C section 610, *Using the Work of Internal Auditors* (AICPA, *Professional Standards*), is effective for audits of financial statements for years ending on or after December 15, 2014.

4.52 The auditor should use such knowledge to

- identify types of potential misstatements.
- consider factors that affect the risks of material misstatement.
- design tests of controls, when applicable, and substantive procedures.

4.53 Obtaining an understanding of internal control is distinct from testing the operating effectiveness of internal control. The objective of obtaining an understanding of internal control is to evaluate the design of controls and determine whether they are implemented for the purpose of assessing the risks of material misstatement. In contrast, the objective of testing the operating effectiveness of internal control is to determine whether the controls, as designed, prevent or detect a material misstatement.

4.54 Paragraph .04 of AU-C section 315 defines *internal control* as "a process effected by those charged with governance, management, and other personnel that is designed to provide reasonable assurance about the achievement of the entity's objectives with regard to the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. Internal control over safeguarding of assets against unauthorized acquisition, use, or disposition may include controls relating to financial reporting and operations objectives." Internal control consists of the following five interrelated components:

a. The control environment

b. The entity's risk assessment process

c. The information system, including the related business processes relevant to financial reporting and communication

d. Control activities relevant to the audit

e. Monitoring of controls (internal audit function discussed in paragraphs 4.65–.66 of this guide)

Refer to paragraphs .15–.25 of AU-C section 315 for a detailed discussion of the internal control components.

4.55 The following list includes examples of unique characteristics of a government's environment and its internal control that the auditor may consider in assessing the risks of material misstatement:

- Members of senior management and the governing board are elected officials or report to elected officials and therefore often are subject to political influences.
- Elected officials may focus on solutions that are popular with the voting public rather than less popular solutions. This focus could result in decisions that benefit the short-term rather than long-term.
- The governing board usually holds its meeting in public.
- The press and citizens often hold management and governing board decisions and otherwise seemingly insignificant matters up to substantial scrutiny.
- Management and governing board actions often are mandated or otherwise affected by laws, regulations, and provisions of contracts and grant agreements.

- GAAP financial statements should conform to GASB standards and governmental financial statements at times are required to conform to accounting and financial reporting requirements established by another government with financial reporting oversight responsibilities.
- Management is, or those charged with governance are, required by law or some other regulation to respond to results of audits and regulatory and grantor reviews.
- Limited financial resources, limitations on the ability to create new revenue sources, or both, coupled with unfunded mandates for services, may result in officials asking management and staff to do more with less.
- Elected officials sometimes utilize excess revenues during times of economic growth rather than to create reserves for future budget shortfalls.
- Generous retirement benefits and a disciplinary structure that often requires numerous levels of approval create a relatively stable work force even though salary structures are often below the market.
- Existence of organized labor in key functions such as law enforcement, fire and rescue, education, health care, and public works may create fiscal challenges for the entity during times of flat or declining revenues.
- The hierarchical structure of government organizations in general, and certain functions specifically (that is, law enforcement, fire and rescue, and so on), may create an environment that is inflexible or resistant to change.

4.56 In acquiring an understanding of and assessing internal control, the auditor should consider information technology controls (commonly referred to as IT controls) as well as the controls over the manual portions of the system (See AU-C section 315). Further, when an entity obtains computer or other services from another organization and if those services are part of the entity's information system, AU-C section 402, *Audit Considerations Relating to an Entity Using a Service Organization* (AICPA, *Professional Standards*), provides requirements and guidance on the factors auditors (referred to as user auditors) should consider when auditing financial statements of an entity that uses a service organization to process certain transactions. Such guidance includes information about the situations in which to consider the effect of the service organization's controls on user organization's controls and how to consider the effect of those controls. Governments use service organizations, for example, to invest bond proceeds and pension plan assets, to serve as third-party administrators for employee health insurance programs, to perform billing services for enterprise activities, to process cash receipts using a lock box arrangement with a financial institution, and to collect taxes.[14] AU-C section 402 requires the auditor to evaluate the significance of the controls of the service organization to those of the user organization and available information about the service organization controls. The user auditor may conclude that the auditor has the

[14] Sometimes services organizations are other governments. For example, counties sometimes collect property taxes for cities, towns, villages, and school districts within the county and states sometimes collect income and sales taxes for other governments within the state.

means from that available information to obtain a sufficient understanding of internal control to assess the risks of material misstatement. Or, instead, the auditor might conclude that there is a need to obtain specific information from the service organization, to perform procedures at the service organization, or to have a service auditor perform procedures. As an aside, AT-C section 320, *Reporting on an Examination of Controls at a Service Organization Relevant to User Entities' Internal Control Over Financial Reporting* (AICPA, *Professional Standards*), and the AICPA Guide *Service Organizations—Reporting on Controls at a Service Organization Relevant to User Entities' Internal Control Over Financial Reporting* provide guidance for independent auditors (service auditors) who issue reports on processing of transactions by service organizations for use by other auditors.

4.57 Often, governments maintain their accounting systems on a basis of accounting other than GAAP, such as the cash or their budgetary basis of accounting. At year-end, those governments may prepare worksheets to convert their accounting system information as needed for the basic financial statements, rather than enter conversion data into their transaction processing systems. (See the further discussion of this matter in paragraph 4.37 and chapter 17.)

Assessment of Risks of Material Misstatement and the Design of Further Audit Procedures

4.58 As discussed previously, risk assessment procedures allow the auditor to gather the information necessary to obtain an understanding of the entity, its environment, and its internal control. This knowledge provides a basis for assessing the risks of material misstatement of the opinion units. These risk assessments are then used to design further audit procedures, such as tests of controls, substantive tests, or both. This section provides guidance on assessing the risks of material misstatement and how to design further audit procedures that effectively address these risks.

4.59 Paragraph .26 of AU-C section 315 states that the auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures. In the context of a governmental audit, "financial statement level" means at the level of each opinion unit, as described in paragraph 4.67, previously. For this purpose, the auditor should

- *a.* identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and considering the classes of transactions, account balances, and disclosures in the financial statements;
- *b.* assess the identified risks and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many other assertions;
- *c.* relate the identified risks to what can go wrong at the relevant assertion level, taking account of relevant controls that the auditor intends to test; and
- *d.* consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement of an opinion unit.

4.60 The auditor should use information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, as audit evidence to support the risk assessment. The auditor should use the assessment of the risks of material misstatement at the relevant assertion level as the basis to determine the nature, timing, and extent of further audit procedures to be performed.

Identification of Significant Risks

4.61 As part of the assessment of the risks of material misstatement, the auditor should determine which of the risks identified are, in the auditor's judgment, risks that require special audit consideration (such risks are defined as *significant risks*). One or more significant risks normally arise on most audits. In exercising this judgment, the auditor should consider inherent risk to determine whether the nature of the risk, the likely magnitude of the potential misstatement including the possibility that the risk may give rise to multiple misstatements, and the likelihood of the risk occurring are such that they require special audit consideration. In considering the nature of the risks, the auditor should consider a number of matters, including whether the risk is related to fraud; recent significant economic, accounting, or other developments; complexity of transactions; whether the risk involves significant transactions with related parties; the degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual. Examples of some risk areas pertaining to government audits could include valuation of derivative instruments and alternative investments; landfill and pollution remediation liability estimates; postemployment benefits other than pensions (OPEB) and pension disclosures, valuation of OPEB and pension liabilities; and tax, grant, and donor restrictions. If the auditor has determined that a significant risk exists, the auditor should obtain an understanding of the government's controls relevant to that risk and evaluate whether those controls have been suitably designed and implemented to mitigate such risks. Furthermore, if the auditor has determined that an assessed risk of material misstatement at the relevant assertion level is a significant risk, the auditor should perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures should include tests of details.

Designing and Performing Further Audit Procedures

4.62 AU-C section 330 addresses the auditor's responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with AU-C section 315 and to evaluate the audit evidence obtained in an audit of financial statements.

4.63 In a governmental audit, to reduce audit risk to an acceptably low level, the auditor (*a*) should determine overall responses to address the assessed risks of material misstatement at the opinion unit level and (*b*) should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the relevant assertion level. The purpose is to provide a clear linkage between the nature, timing, and extent of the auditor's further audit procedures and the assessed risks. The overall responses and the nature, timing, and extent of the further audit procedures to be performed are matters for the professional judgment of the auditor and should be based on the auditor's assessment of the risks of material misstatement.

Overall Responses

4.64 The auditor's overall responses to address the assessed risks of material misstatement at the opinion unit level may include emphasizing to the audit team the need to maintain professional skepticism, assigning more experienced staff or those with specialized skills or using specialists, providing more supervision, incorporating additional elements of unpredictability in the selection of further audit procedures to be performed, or making general changes to the nature, timing, or extent of audit procedures. For example, varying the dollar amount of the threshold used to search for unrecorded liabilities from year-to-year is effective when the risk of material misstatement is high due to improperly segregated duties.

The Internal Audit Function

4.65 State and local governments frequently establish an internal audit organization; large governments sometimes establish separate internal audit organizations for separate departments. The responsibilities of internal audit organizations can vary significantly—from monitoring control activities to providing assurance and consulting activities designed to add value and improve an organization's operations and its risk management, control, and governance processes. The internal audit organization usually attempts to maintain its independence from the executive, legislative, or judicial branches although, administratively, it may report to one or more of them.[15] An important responsibility of the internal audit function is to monitor the performance of an entity's controls. If the government has an internal audit function, the auditor should obtain an understanding of the nature of its responsibilities and how it fits into the government's organizational structure and the activities performed or to be performed to determine whether the internal control function is likely to be relevant to the audit. The extent of the procedures necessary to obtain this understanding will vary, depending on the nature of those activities.

4.66 An internal audit function may affect an organization's internal control in two ways. First, the function usually increases the attention devoted to internal control. Second, to the extent the function is responsible for a continuing evaluation of internal control, it serves the important role of monitoring internal control. An internal audit organization also may be responsible for monitoring compliance by the entity's grantees and subgrantees with the provisions of grant agreements. Independent auditors may be able to coordinate efforts with the internal audit organization and use their efforts to provide audit evidence. AU-C section 610 discusses the effects of internal audit organizations on the audit.[16]

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[15] Auditors employed by state and local governments sometimes may be considered independent. See paragraph 4.27.

[16] See footnote 14.

Update 4-1 *Fiduciary Activities*

GASB Statement No. 84, *Fiduciary Activities*, establishes criteria for identifying and reporting fiduciary activities. The criteria for identification of fiduciary activities primarily focuses on (a) whether a government controls the assets of the fiduciary activity and (b) the beneficiaries with whom a fiduciary relationship exists.

Governments with activities meeting the criteria will present a statement of fiduciary net position and a statement of changes in fiduciary net position, with certain exceptions.

There are four classifications of fiduciary funds described in GASB Statement No. 84: (1) pension (and other employee benefit) trust funds, (2) investment trust funds, (3) private-purpose trust funds, and (4) custodial funds. Custodial funds should report fiduciary activities that are not held in a trust or equivalent arrangement that meets specific criteria. Note that agency funds will no longer be reported upon application of this statement.

The statement was issued in January 2017 and is effective for fiscal years beginning after December 15, 2018. Earlier application is encouraged.

Upon its effective date, GASB Statement No. 84 will affect the guidance in this chapter.

The full text of the statement is available on GASB's website at www.gasb.org.

Materiality in Planning and Performing an Audit

4.67 This section describes how the nature of the governmental financial reporting model is the basis for how materiality is determined in an audit of governmental financial statements. It also describes how materiality determinations for purposes of preparing a government's basic financial statements differ from materiality determinations for purposes of planning, performing, evaluating the results of, and reporting on the audit of a government's basic financial statements.

4.68 As described in chapter 2, governments generally are required to include in their basic financial statements both government-wide financial statements and fund financial statements. GASB standards require those financial statements to present certain disaggregated information. For example, GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, as amended, requires the government-wide statement of net position and statement of activities, which display information about the government as a whole, to include separate rows and columns to distinguish between the governmental and business-type activities of the primary government and also between the primary government and its discretely presented component units. The fund financial statements are required to report additional and detailed information about the primary government's funds, including its blended component units. Separate sets of financial statements are required for each fund category—governmental, proprietary, and fiduciary—and each statement is required to present a number of different columns. For example, the governmental fund financial statements are required to present separate columns for the financial information for each major governmental fund, for the nonmajor governmental funds in the aggregate, and for total governmental funds.

GASB Guidance to Preparers on Materiality Determinations

4.69 Questions 7.4.1–7.4.6 of the GASB *Implementation Guide No. 2015-1* (GASB IG 2015-1) explain how preparers should view governmental financial statements in applying materiality determinations. That view is based on the requirements in GASB standards to report separate financial statements or information for various reporting units, as shown in exhibit 4-1. Question 7.4.1 of the GASB IG 2015-1 indicates that preparers should make separate materiality evaluations for the governmental activities; the business-type activities; and each major governmental and enterprise fund because those reporting units are considered to be quantitatively material. That question also states that the components of the remaining fund information—nonmajor governmental and enterprise funds, internal service funds, and fiduciary funds—may or may not be quantitatively material. It states that the preparer's view of the data presented for those reporting units for purposes of materiality evaluations should be based on professional judgment considering relevant qualitative factors and the relationship of the remaining fund reporting units to other appropriate information in the financial statements. Question 7.4.2 of the GASB IG 2015-1 indicates that materiality assessments for the reconciliations between the fund financial statements and the government-wide financial statements should be considered in conjunction with the government-wide financial statements. Note that those reconciliations are presented on the fund financial statements or in schedules that accompany those statements.

4.70 Questions 7.4.4–7.4.6 of the GASB IG 2015-1 discuss how preparers should view the data for discretely presented component units for purposes of materiality evaluations. Question 7.4.5 states that assessment of major individual discretely presented component units should consider certain characteristics of the major component unit information and be based on an evaluation of the nature and significance of the unit's relationship to the primary government. See also GASB IG 2015-1 question 4.28.17, which provides further guidance on "significance" for determining major component units. Question 7.4.6 states that the preparer's view of the data presented for component unit information when there are no major component units for purposes of materiality evaluations should be based on professional judgment. That judgment includes considering relevant qualitative factors and the relationship of the nonmajor component units' information to other appropriate information in the government's financial statements.

Auditor Materiality Determinations

4.71 AU-C section 320 addresses the auditor's responsibility to apply the concept of materiality in planning and performing an audit of financial statements. The auditor's determination of materiality is a matter of professional judgment and is affected by the auditor's perception of the financial information needs of users of financial statements. AU-C section 450, *Evaluation of Misstatements Identified During the Audit* (AICPA, *Professional Standards*), explains how materiality is applied in evaluating the effect of identified misstatements on the audit and the effect of uncorrected misstatements, if any, on the financial statements. In planning the audit, the auditor makes judgments about the size of misstatements that will be considered material. Although it is not practicable to design audit procedures to detect misstatements that could be material solely because of their nature (that is, qualitative considerations), the auditor considers not only the size but also the nature of uncorrected misstatements, and the particular circumstances of their occurrence, when evaluating their effect on the financial statements.

Planning Materiality

4.72 In accordance with paragraph .10 of AU-C section 320, when establishing the overall audit strategy, the auditor should determine materiality for the financial statements as a whole, which, in the context of a governmental audit, means establishing materiality levels by each opinion unit as further discussed in paragraph 4.73. Materiality and audit risk are considered throughout the audit, in particular when

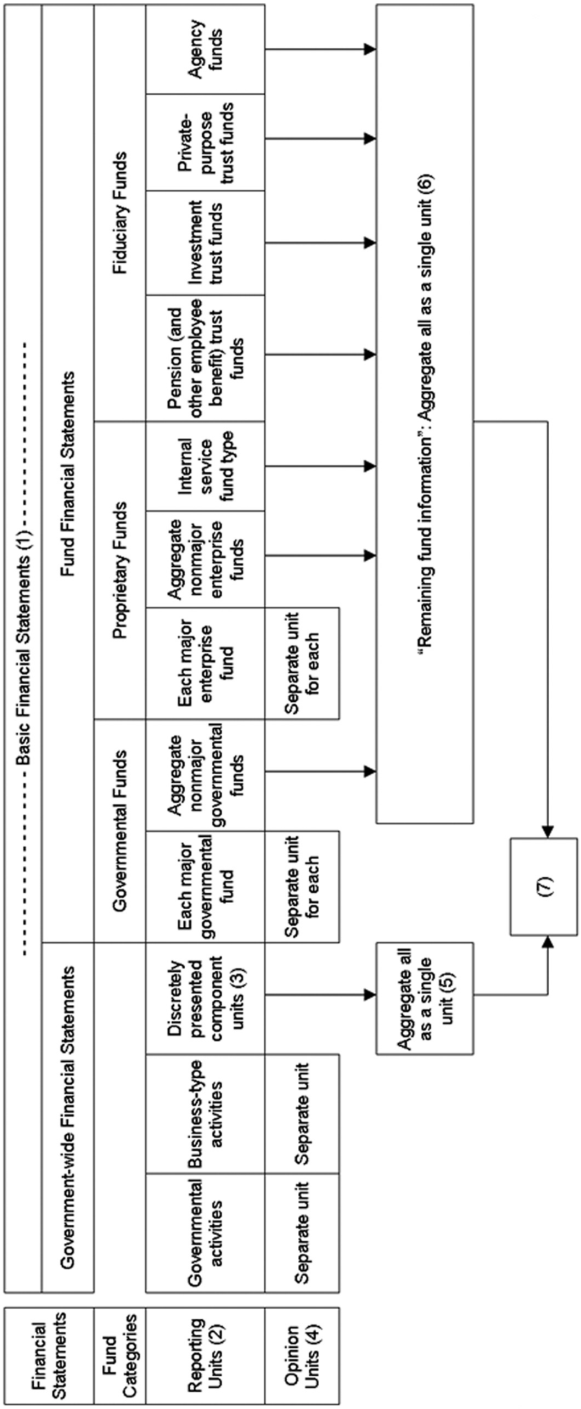
- *a.* determining the nature and extent of risk assessment procedures to be performed.
- *b.* identifying and assessing the risks of material misstatement.
- *c.* determining the nature, timing, and extent of further audit procedures. Properly designed further audit procedures increase the likelihood that you will detect any material misstatement that exists in the financial statements.
- *d.* evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming an opinion in the auditor's report.

Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. Considerations affecting an appropriate benchmark are provided in paragraphs .A5–.A7 of AU-C section 320.

4.73 As noted in paragraph 4.72, because of the unique nature of governmental financial reporting, the auditor's consideration of whether a government's basic financial statements are presented fairly, in all material respects, in accordance with GAAP, should be based on opinion units, as shown in exhibit 4-1 and as discussed in paragraphs 4.74–.77.

Exhibit 4-1

Overview of Reporting Units and Opinion Units



NOTE: GASB Statement No. 34, as amended, requires the presentation, at the bottom of the governmental fund financial statements or in an accompanying schedule, of reconciliations from governmental funds to governmental activities in the government-wide financial statements. It also requires the presentation, at the bottom of the proprietary fund financial statements or in an accompanying schedule, of reconciliations from enterprise funds to business-type activities in the government-wide financial statements, if applicable. In planning, performing, evaluating the results of, and reporting on the audit, the auditor should consider the information presented in the financial statement reconciliations as relating to the governmental activities and business-type activities opinion units.

(1) The basic financial statements also include notes to the financial statements that are essential to fair presentation of the financial statements. Chapter 15 discusses the effect of opinion units on the auditor's evaluation of note disclosures.

(2) Reporting units represent the separate columnar displays required by GASB standards.

(3) Financial reporting alternatives exist for the display of discretely presented component units. See discussion in footnote 19 and chapter 3.

(4) These are the opinion units required for an audit of government's basic financial statements. An auditor may be engaged to set the scope of the audit and assess materiality at a more-detailed level than the opinion units required for the basic financial statements, as discussed in paragraphs 4.86–.87.

(5) Except as indicated in (7), auditors should make a single quantitative materiality evaluation for the aggregate discretely presented component units, and apply quantitative materiality to those component units independently of the quantitative evaluations they make for other opinion units and regardless of how major component units are reported in the basic financial statements. That quantitative evaluation along with quantitative materiality factors should affect the nature, timing, and extent of audit procedures applied to the financial information of individual discretely presented component units that comprise the opinion unit. See paragraph 4.75.

(6) Except as indicated in (7), auditors should make a single quantitative materiality evaluation for the remaining fund information, and apply quantitative materiality to that remaining fund information independently of the quantitative evaluations they make for other opinion units. That quantitative evaluation along with quantitative materiality factors should affect the nature, timing, and extent of audit procedures applied to the financial information of individual funds that comprise the opinion unit. See paragraph 4.75.

(7) As explained in paragraph 4.76, under certain circumstances auditors may choose to combine the two aggregate opinion units—the one for the aggregate discretely presented component units and the one for the aggregate remaining fund information—into a single opinion unit referred to as the aggregate discretely presented component unit and remaining fund information opinion unit. Auditors should apply quantitative materiality to that combined aggregate opinion unit independently of the quantitative evaluations they make for other opinion units and regardless of how major component units are reported in the basic financial statements. That quantitative evaluation along with quantitative materiality factors should affect the nature, timing, and extent of audit procedures applied to the financial information of individual discretely presented component units and funds that comprise the opinion unit.

4.74 Auditors should make separate materiality determinations for purposes of planning, performing, evaluating the results of, and reporting on the audit of a government's basic financial statements for each opinion unit. Except as discussed in paragraph 4.82, the opinion units in a government's basic financial statements are (as applicable) the governmental activities; the business-type activities; the aggregate discretely presented component units; each major governmental and enterprise fund;[17] and the aggregate remaining fund information (nonmajor governmental and enterprise funds, the internal service fund type, and the fiduciary fund types). The auditor should view the financial statement reconciliations presented on the fund financial statements or in an accompanying schedule as relating to the presentation of the governmental activities and business-type activities opinion units. Chapters 14–15 discuss how the auditor should evaluate misstatements and express opinions in the auditor's report separately for each opinion unit.

4.75 Audit materiality is based on the opinion units indicated previously because, as established in GASB Statement No. 34, as amended, and explained in paragraph 13 of the GASB IG 2015-1, a government's basic financial statements highlight a primary government's governmental activities, its business-type activities, and each of its major governmental and enterprise funds. As a general rule, the other information presented in a government's basic financial statements is separated into two opinion units—the aggregate remaining fund information and the aggregate discretely presented component units. Those groupings distinguish financial information for the primary government from financial information for its discretely presented component units. (See also paragraph 4.76.) The auditor should make materiality evaluations for each opinion unit separately. That is, the materiality evaluation for one opinion unit should not be affected by other information in the government's financial statements or by quantitative or qualitative factors relating to other opinion units. Also, in the audit of a government's basic financial statements, the auditor should not establish more than one opinion unit for the aggregate remaining fund information, even though, as discussed in paragraph 4.69, paragraph 13 of the GASB IG 2015-1 advises preparers to consider disaggregating the remaining fund information for purposes of materiality evaluations. Similarly, auditors should not establish more than one opinion unit for the aggregate discretely presented component units, regardless of how major component units are reported in the basic financial statements.[18] (Paragraphs 4.86–.87 discuss how auditors may set the scope of the audit at a more-detailed level.) However,

[17] Major governmental and enterprise funds are separate opinion units regardless of whether (*a*) they meet the quantitative criteria in GASB Statement No. 34, as amended, for reporting as major or (*b*) the government voluntarily decides to report them as major because they are particularly important to financial statement users.

[18] As discussed in chapter 3, "The Financial Reporting Entity," information about each major component unit can be provided by (*a*) presenting each major component unit in a separate column in the government-wide financial statements, (*b*) including combining statements of major component units in the basic financial statements after the fund financial statements, or (*c*) presenting condensed financial statements in the notes to the financial statements.

because of the various, potentially diverse information comprising the aggregate opinion units (that is, the aggregate remaining fund information and the aggregate discretely presented component units, or the combination of those two, as discussed in paragraph 4.76), the auditor should consider how qualitative and quantitative factors relating to the components of each aggregate unit will affect the nature, timing, and extent of audit procedures on that unit. Regardless of how the auditor designs and performs audit procedures for each opinion unit (including the aggregate opinion units), the auditor's report on the basic financial statements should either express an opinion regarding the financial statements for each opinion unit, or assertions to the effect that an opinion on one or more opinion units cannot be expressed, as discussed in chapter 16.

4.76 Normally, as discussed in paragraphs 4.86–.87, the aggregate discretely presented component units and the aggregate remaining fund information are treated as separate opinion units. In some cases, however, the aggregate discretely presented component unit opinion unit is not quantitatively or qualitatively material to the primary government. For example, the reporting entity may have a single, small component unit and there are no qualitative factors that make that component unit material to the primary government. In other cases, the aggregate remaining fund information opinion unit is not quantitatively or qualitatively material to the primary government. For example, the primary government may have only a few, small nonmajor governmental or enterprise funds (and no internal service or fiduciary funds) and there are no qualitative factors that make those funds material to the primary government. In either of those situations, auditors may choose to combine the two aggregate opinion units—the one for the aggregate discretely presented component units and the one for the aggregate remaining fund information—into a single opinion unit for purposes of planning, performing, evaluating the results of, and reporting on the audit of the government's basic financial statements. That combined opinion unit is referred to as the "aggregate discretely presented component unit and remaining fund information" opinion unit. Even if that combined aggregate opinion unit is not material to the primary government, no further aggregation of that opinion unit with other of the government's opinion units is permitted. Similarly, no further aggregation is permitted if the government has only the aggregate discretely presented component unit opinion unit or only the aggregate remaining fund information opinion unit, and that opinion unit is not material to the primary government.

4.77 Auditors should determine opinion units for audits of a special-purpose government's basic financial statements in the same manner as for general-purpose governments:

- A government that is engaged in a single governmental program and that combines its fund financial statements and government-wide financial statements, as provided in paragraph 136 of GASB Statement No. 34, as amended, will have an opinion unit for each major governmental fund, an opinion unit for its aggregate nonmajor governmental funds, if any, and an opinion unit for the government-wide total column, which represents governmental activities.
- A government that is engaged only in business-type activities and that presents more than one enterprise fund (such as a utility district that provides water, sewer, electric, and refuse operations)

will have an opinion unit for each major enterprise fund and another opinion unit for its aggregate nonmajor enterprise funds, if any, which represents "aggregate remaining fund information."[19]

- A government that is engaged only in fiduciary activities has only one opinion unit that represents, in effect, "remaining fund information." For a public employee retirement system with more than one defined benefit pension plan that is administered through a trust that meets the specified criteria that presents separate financial statements for each plan, as required by GASB standards, those separate plan financial statements do not represent separate opinion units but rather are aggregated into a single opinion unit.
- If a special-purpose government has one or more discretely presented component units, the component unit, or the aggregate of those component units, is an opinion unit separate from the government's other opinion unit(s), unless the aggregate component units meet the conditions for combining with the aggregate remaining fund information, as discussed in paragraph 4.76.

Quantitative and Qualitative Materiality Factors

4.78 The auditor should plan the audit to obtain reasonable assurance of detecting misstatements that the auditor believes could be large enough, individually or in the aggregate, to be quantitatively material to the financial presentation of an opinion unit. Auditors may establish a single measure or multiple measures of quantitative materiality for each opinion unit in designing and performing audit procedures. As a practical approach to establishing multiple measures of quantitative materiality for an individual opinion unit, the auditor may consider qualitative factors such as whether large-dollar activity or balances might distort quantitative materiality for the unit. For example, the governmental activities opinion unit may have significant amounts of general capital assets, including infrastructure assets that are as large as, if not larger than, all of the other assets of that opinion unit. In that case, the auditor may wish to take a two-tiered approach to establishing quantitative materiality and develop one set of measures for considering general capital asset activity and balances and another set of measures for considering activity and balances relating to other than general capital assets. Other accounts that similarly could distort quantitative materiality considerations for an opinion unit include investments, debt, and special and extraordinary items. However, as stated in paragraph 4.75, regardless of how the auditor designs and performs audit procedures for each opinion unit, the auditor's report on the basic financial statements should express an opinion for each opinion unit or state that an opinion cannot be expressed.

Lesser Materiality for Particular Items

4.79 Consistent with paragraph .10 of AU-C section 320, when establishing the overall strategy for the audit, the auditor should consider whether, in

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[19] Some special-purpose governments engaged only in business-type activities report fiduciary activities in fiduciary funds. GASB Statement No. 34 does not require those governments to present a government-wide financial statement because the activity reported in fiduciary funds is not part of government-wide financial statements. In those situations, the fiduciary funds are part of the remaining fund information opinion unit.

the specific circumstances of the entity, misstatements of particular items of lesser amounts than the materiality levels determined for each opinion unit, as discussed in paragraph 4.67, if any, could, in the auditor's judgment, reasonably be expected to influence economic decisions of users taken on the basis of the financial statements. Any such amounts determined represent lower materiality levels to be considered in relation to the particular items in the opinion units.

4.80 In making this judgment, the auditor should consider factors such as the following:

- Whether accounting standards, laws, or regulations affect users' expectations regarding the measurement or disclosure of certain items
- The key disclosures in relation to the government and the environment in which the entity operates

Performance Materiality

4.81 As discussed in paragraph .10 of AU-C section 320, when assessing the risks of material misstatements and designing and performing further audit procedures to respond to the assessed risks, the auditor should allow for the possibility that some misstatements of lesser amounts than the materiality levels determined in accordance with paragraph .10 of AU-C section 320 could, in the aggregate, result in a material misstatement of an opinion unit. To do so, the auditor should determine *performance materiality* for purposes of assessing the risks of material misstatement and determining the nature, timing, and extent of further audit procedures. In a governmental audit, performance materiality is the amount or amounts set by the auditor at less than materiality for an opinion unit to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the opinion unit. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances, or disclosures.

4.82 As the audit progresses, the auditor should revise materiality for an opinion unit (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) if the auditor becomes aware of information that would have caused a materiality determination of a different amount initially. If the auditor concludes a lower materiality than initially determined is appropriate, the auditor should determine whether it is necessary to revise performance materiality and whether the nature, timing and extent of further audit procedures remain appropriate.

4.83 The auditor should perform the audit to obtain reasonable assurance of detecting misstatements that the auditor believes could be large enough, individually or in the aggregate, to be quantitatively material to an opinion unit. Although the auditor should be alert for misstatements that could be qualitatively material, it ordinarily is not practical to design audit procedures to detect them.

4.84 As indicated previously, judgments about materiality include both quantitative and qualitative information. As a result of the interaction of quantitative and qualitative considerations in materiality judgments, misstatements of relatively small amounts that come to the auditor's attention could have a material effect on an opinion unit. Qualitative considerations also influence the auditor in reaching a conclusion about whether misstatements are material. Paragraph .A23 of AU-C section 450 provides qualitative factors that the auditor may consider relevant in determining whether misstatements are material. Also see the discussion of the consideration of qualitative factors in evaluating opinion unit misstatements in chapter 15.

Tolerable Misstatement

4.85 AU-C section 530, *Audit Sampling* (AICPA, *Professional Standards*), defines *tolerable misstatement* as the monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population and provides further guidance about the concept.

More Detailed Materiality Levels

4.86 Because of the terms of the audit engagement, the auditor may set the scope of the audit and assess materiality at a more detailed level than by the opinion units required for the basic financial statements (for example, at an individual fund or fund type level). In many cases, the more detailed level is required by legal or contractual provisions, such as state law, debt covenants, or grant or contribution agreements.

4.87 A more detailed audit scope supplements, rather than replaces, the scope of the audit on a government's basic financial statements. That is, the auditor should continue to plan, perform, evaluate the results of, and report on the audit of the basic financial statements based on the opinion units described in paragraph 4.67. The auditor also should plan, perform, evaluate the results of, and report on the entity's financial statements at the more detailed level by establishing additional opinion units corresponding to the expanded scope. Chapter 16 discusses how a more detailed audit scope affects the auditor's report.

Performing Further Audit Procedures

4.88 Further audit procedures provide important audit evidence to support an audit opinion. These procedures consist of tests of controls and substantive tests. The nature, timing, and extent of the further audit procedures to be performed by the auditor should be based on the auditor's assessment of risks of material misstatement at the relevant assertion level.

4.89 In some cases, an auditor may determine that performing only substantive procedures is appropriate. However, the auditor often will determine that a combined audit approach using both tests of the operating effectiveness of controls and substantive procedures is an effective audit approach.

4.90 The auditor should design and perform tests of controls when the auditor's risk assessment includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the relevant assertion level. In governmental audits, tests of controls may be more efficient and effective than substantive tests alone, for example, for expenditures and significant revenue collections, such as taxes or utility billings. Additionally, the nature and complexity of the systems the entity uses to process and control information supporting the assertion may need to be considered when developing the audit strategy. For example, if the billing process is heavily reliant on IT controls to initiate, authorize, record, process, and report transactions, it may be more cost effective or even necessary to perform tests of controls on both the application and the IT general controls.

4.91 Irrespective of the assessed risks of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure.

4.92 The auditor's substantive procedures should include the following audit procedures related to the financial statement closing process, such as

- agreeing or reconciling the financial statements with the underlying accounting records and
- examining material journal entries and other adjustments made during the course of preparing the financial statements.

As described in paragraph 4.57, governments often maintain accounting systems on a basis of accounting other than GAAP, and prepare journal entries often accompanied by nonsystem worksheets to convert accounting system information as needed for the basic financial statements. The nature and extent of the auditor's examination of journal entries and other adjustments depend on the nature and complexity of the entity's financial reporting system and the associated risks of material misstatement.

Evaluation of Misstatements

4.93 AU-C section 200 describes the auditor's responsibility in a GAAS audit to plan and perform the audit to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. AU-C section 240 expands on that discussion as it relates to fraud. (Appendix A to this chapter discusses the provisions of AU-C section 240.) The auditor should accumulate, by opinion unit, misstatements identified during the audit, other than those that the auditor believes are clearly trivial, and communicate them, on a timely basis, to the appropriate level of management. AU-C section 450 further states that auditors should consider the effects, both individually and in the aggregate, of misstatements that are not corrected by the entity. This consideration includes, among other things, the effect of misstatements related to prior periods.

Related Parties and Transactions

4.94 AU-C section 550, *Related Parties* (AICPA, *Professional Standards*), addresses the auditor's responsibilities relating to related party transactions in an audit, and expands upon how AU-C section 240 and AU-C section 315 are to be applied regarding risks of material misstatement associated with related party relationships and transactions. In a governmental audit, related parties include, but are not limited to, members of the governing board, administrative boards or commissions, administrative officials and their immediate families, component units and joint ventures, and affiliated or related organizations that are not included as part of the financial reporting entity. GASB Statement No. 56, *Codification of Accounting and Financial Reporting Guidance Contained in the AICPA Statements on Auditing Standards*, and paragraphs 54–57 of GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, as amended, define the accounting and reporting requirements of governmental entities for related party transactions (see chapters 3 and 15). Many governments require their officials and employees to periodically file statements to disclose related-party relationships and transactions. Among other procedures, the auditor could review those disclosure statements (or minutes of the governing board or other administrative board or commission meetings where such related party disclosures are discussed) to evaluate the government's identification of related parties and transactions. See the discussion about the financial reporting of related-party transactions in chapter 15.

Group Audit Engagements

4.95 Group audits involve the audit of financial statements that include the financial information of more than one component (group financial statements). An audit of group financial statements involves identifying the components (see paragraphs 4.98–.99) that are part of the group and considering the effect of the components on the overall group audit strategy and group audit plan, including the extent to which the group engagement team will use the work of component auditors. AU-C section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* (AICPA, *Professional Standards*), addresses special considerations that apply to group audits, in particular those that involve component auditors. The applicability of AU-C section 600 depends on whether more than one component is identified, regardless of whether there is another auditor involved. On the other hand, if only one auditor is responsible for all of the opinion units in the financial reporting entity and no components are included, the requirements of AU-C section 600 may not apply. In this situation, the group engagement team may conclude that the financial statements are not group financial statements because there is only one component—the government itself.

4.96 Under AU-C section 600, the group engagement team is required, among other things, to

- obtain an understanding of the group, its components, and their environments including group-wide controls
- establish a group audit strategy
- develop a group audit plan

The understanding described previously should be sufficiently performed to confirm or revise the group engagement team's initial identification of components, including significant components, and to assess the risks of material misstatement due to error or fraud in the audit of the group financial statements.

4.97 The guidance in this section focuses on the aspects of AU-C section 600 that are unique to audits of state and local governments. Auditors should carefully read this guidance in conjunction with AU-C section 600 and understand the importance of the standard's organizational structure. Specifically,

- paragraphs .13–.26 and .32–.50 of AU-C section 600 apply to all group audits.
- additional requirements in paragraphs .27–.30 of AU-C section 600 apply when the group engagement partner decides to make reference to the audit of a component auditor in the auditor's report on the group financial statements.

- additional requirements in paragraphs .31 and .51–.65 of AU-C section 600 apply when the auditor assumes responsibility for the work of a component auditor.

Definition of a Component

4.98 A *component* is an entity or business activity for which group or component management prepares financial information that is required to be included in the group financial statements. A component may include, but is not limited to, subsidiaries, geographical locations, divisions, investments, products or services, functions, processes, or component units of state or local governments. In applying the definition of a component in a governmental audit, it is helpful to consider the intent of AU-C section 600, which is to manage the aggregation risk inherent in the preparation of group financial statements. Accordingly, the auditor should obtain an understanding of the governmental entity, how its activities are managed, the governance structures, and how financial information is recorded in the accounting system and aggregated into the financial statements. The use of fund accounting by itself does not result in a component. Fund accounting is a mechanism to demonstrate accountability with the restrictions on resource inflows.

4.99 The term *component* used in applying the provisions of AU-C section 600 is different from the term *component unit* as defined by GASB. GASB defines *component units* as legally separate organizations for which elected officials of the government are financially accountable (see chapter 3) and provides for the inclusion of these organizations in the basic financial statements of a primary government as *component units*, where appropriate. Although a *component unit*, as defined by GASB, will meet the definition of a *component* under AU-C section 600, the governmental reporting entity may include additional components because the definition of a *component* is much broader than the definition of a *component unit*.

Opinion Units

4.100 A unique aspect of financial reporting by governmental entities, which affects the application of AU-C section 600 in a governmental audit is that the financial statements often include multiple opinion units which the auditor is required to report separately thereon based on separate audits performed in accordance with the respective performance materiality of each opinion unit (as discussed in paragraphs 4.81–.84 and chapter 16). Accordingly, it can be analogized that each opinion unit is equivalent to its own group and likely there would be no additional requirements under AU-C section 600 unless the opinion unit contains components or is audited by other auditors. This concept is illustrated in exhibit 4-2.

> *For example*, assume a utility fund, which is reported as a major enterprise of a City, has historically operated on an autonomous basis from a City. The utility has different management which is accountable to a utility board. The accounting information for the utility included in the City's basic financial statements is prepared separately by management of the utility. Although the utility appears to meet the definition of a component, there would be no additional procedures required to be performed under AU-C section 600 because the utility is being audited as a major fund and the utility itself does not have any components.

In contrast, if the utility is not a major fund, the requirements of AU-C section 600 would apply because the utility would be a component of the aggregate remaining fund information. In this situation, the group auditor would establish component materiality for the utility and perform audit procedures based on the significance of the component (utility) and the assessed risk of material misstatement in relation to the group (aggregate remaining fund information).[20]

4.101 The financial statements of the governmental and business-type activities would not normally need to be considered when identifying components. These financial statements are formed by combining the financial statements of the of the underlying major funds and aggregate remaining fund information, all of which are separate opinion units for which the auditor expresses separate opinions. Accordingly, there would be no additional procedures to be performed under AU-C section 600. Audit procedures on the required reconciliations (for example, procedures on the reconciling items for capital assets and long-term debt) should be performed using the performance materiality of the respective opinion units.

4.102 If an opinion unit, or component thereof, is audited by another auditor, and the other auditor's work on the financial information will be used as audit evidence for the group audit, the opinion unit or the component thereof would be considered a component under AU-C section 600, and the group auditor should follow the AU-C section 600 guidance related to component auditors.

4.103 Opinion units that commonly have more than one component include the aggregate remaining fund information and aggregate discretely presented component units. The aggregate remaining fund information often includes pension trust funds, investment trust funds, and similar activities for which there is a separate governance structure (board), management, and accounting for the different activities. Similarly, the aggregate discretely presented component units often have more than one component unit. Each component unit, by definition, is legally separate and usually has a separate governance structure.

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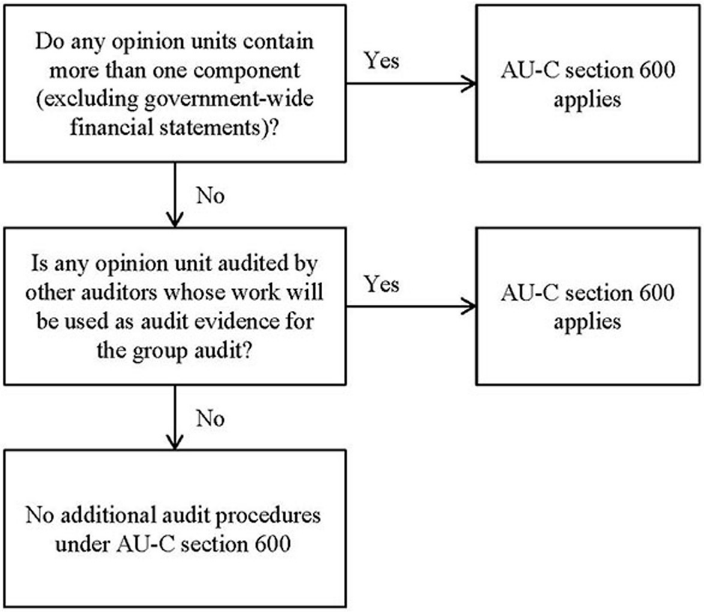
[20] The example in paragraph 4.100 is from the perspective of applying AU-C section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* (AICPA, *Professional Standards*), to individual opinion units. The group engagement partner for the primary government should consider whether additional procedures are required by AU-C section 600 related to the entire financial reporting entity. For example, if other auditors are involved, there are additional requirements under AU-C section 600 to consider.

Exhibit 4-2

Applying AU-C Section 600 in Audits of Governmental Entities



Identifying Components in State and Local Governments Group Audits

4.104 Factors that auditors may consider in identifying components for state and local governments include the following:

- Governance, legal, and management structures
- Decentralization of operations
- Outsourcing of operations
- Nature of activities and uniqueness of relationship to the entity
- Control environment

4.105 AU-C section 600 always applies if the governmental entity has an equity method investment or when a component of the entity is audited by other auditors. The other factors described previously require the use of professional judgment in identifying components in audits of governmental entities and the application of AU-C section 600.

Significant Components

4.106 As the individual financial significance of a component increases, the risks of material misstatement of the group financial statements ordinarily increase. AU-C section 600 defines a *significant component* as a component identified by the group engagement team (*a*) that is of individual financial significance to the group, or (*b*) that, due to its specific nature or circumstances, is likely to include significant risks of material misstatements of the group financial statements.

4.107 The group engagement team may apply a percentage to a chosen benchmark as an aid to identify components that are of individual financial significance. Identifying a benchmark and determining a percentage to be applied to it involve the exercise of professional judgment. In audits of governmental entities, appropriate quantitative benchmarks for identifying significant components might include net costs or total budget. Qualitative considerations may involve matters of heightened public sensitivity (for example, national security issues, donor-funded projects, or reporting of tax revenue).

Materiality

4.108 Paragraph .32 of AU-C section 600 requires the group engagement team to determine materiality, including performance materiality, for (*a*) the group financial statements as a whole and (*b*) particular account balances, classes of transactions, or disclosures in certain circumstances. In addition, the group engagement team is required to determine materiality for components on which the group engagement team will perform, or for which the auditor of the group financial statements will assume responsibility for the work of a component auditor who performs an audit or review (adapted as necessary to meet the needs of the group engagement team). To implement these requirements, the group engagement team should first identify all components because component materiality takes into account all components, regardless of whether reference is made to the audit of a component auditor in the auditor's report on the group financial statements. To reduce the risk that the aggregate of uncorrected and undetected misstatements in the group financial statements exceeds the materiality for the group financial statements as a whole, the group engagement team should establish component materiality at a lower materiality than that for the group financial statements as a whole. Component performance materiality should be lower than performance materiality for the group financial statements as a whole. Different materiality may be established for different components, and the aggregate of component materiality may exceed group materiality.

4.109 Because of the unique nature of governmental financial reporting, the auditor's consideration of materiality is based on the opinion units. Accordingly, when there are two or more components within an opinion unit, the group auditor is required to establish component materiality and component performance materiality for each component at a level lower than that for the opinion unit. If the group auditor is making reference to the component auditor, the group engagement team is not required to communicate the component materiality to the component auditors.

Using the Work of Others

Deciding to Act as Auditor of Group Financial Statements

4.110 The group engagement partner decides to act as the auditor of the group financial statements and report as such on the group financial statements upon evaluating whether the group engagement team will be able to obtain sufficient appropriate audit evidence through the group engagement team's work or use of the work of component auditors. Relevant factors in making this determination include, among other things, the (*a*) individual financial significance of the components for which the auditor of the group financial statements will be assuming responsibility, (*b*) extent to which significant risks of material misstatements of the group financial statements are included in the components for which the auditor of the group financial statements will be assuming responsibility, and (*c*) extent of the group engagement team's knowledge of the overall financial statements.

4.111 In audits of state and local governments, additional factors to consider include (*a*) engagement by the primary government as the auditor of the financial reporting entity and (*b*) responsibility for auditing the primary government's general fund (or other primary operating fund).

Understanding With Component Auditors

4.112 Regardless of whether reference will be made in the auditor's report on the group financial statements to the audit of a component auditor, the group engagement team should obtain an understanding of

- whether a component auditor understands and will comply with the ethical requirements that are relevant to the group audit and, in particular, is independent.
- a component auditor's professional competence.
- the extent, if any, to which the group engagement team will be able to be involved in the work of the component auditor.
- whether the group engagement team will be able to obtain information affecting the consolidation process from a component auditor.
- whether a component auditor operates in a regulatory environment that actively oversees auditors.

4.113 When the group engagement team has serious concerns about the professional competence of the component auditor or the component auditor does not meet the independence requirements that are relevant to the group audit, *the group auditor cannot use the work of the other auditors or make reference to the other auditors in their report*. This requirement may have significant implications in audits of governments because of the potentially separate legal status and governance structure of entities included within the reporting entity, and the inability of group management to control or influence the contracting relationship between component management and component auditors. In these cases, the group auditor may not have the ability to step in and perform the necessary audit work for the component, resulting in a scope limitation.

Making Reference to Component Auditors

4.114 After gaining an understanding of each component auditor, the group engagement partner should decide whether to make reference to a component auditor in the auditor's report on the group financial statements. As stated in paragraph .25 of AU-C section 600, reference to the audit of a component auditor in the auditor's report on the group financial statements should not be made unless

a. the group engagement partner has determined that the component auditor has performed an audit of the financial statements of the component in accordance with the relevant requirements of GAAS, and

b. the component auditor has issued an auditor's report that is not restricted as to use.

4.115 According to paragraph .26 of AU-C section 600, if the component's financial statements are prepared using a different financial reporting framework from that used for the group financial statements, reference to the audit of a component auditor in the auditor's report on the group financial statements should not be made unless *a.* the measurement, recognition, presentation, and disclosure criteria that are applicable to all material items in the component's financial statements under the financial reporting framework used by the component are similar to the criteria that are applicable to all material items in the group's financial statements under the financial reporting framework used by the group, and

b. the group engagement team has obtained sufficient appropriate audit evidence for purposes of evaluating the appropriateness of the adjustments to convert the component's financial statements to the financial reporting framework used by the group without the need to assume responsibility for, and, thus, be involved in, the work of the component auditor.

4.116 The GASB financial reporting framework allows certain nongovernmental component units, such as foundations, that report under the FASB financial reporting framework, to be incorporated into the reporting entity's financial statements. GASB does not have a requirement to change the recognition, measurement, or disclosure standards applied in a nongovernmental component unit's separate financial statements. In these circumstances, the group auditor may make reference to the audit of a component auditor. If the financial statement format that group management uses to include a FASB component unit requires consolidation adjustments and reclassifications, the auditor should, pursuant to paragraph .36 of AU-C section 600, evaluate the appropriateness, completeness, and accuracy of those adjustments and reclassifications.

Communications Between Group and Component Auditors

4.117 Paragraph .41 of AU-C section 600 requires timely communication between the group engagement team and the component auditor of certain specific items and also requires that the communications about the group engagement team's requirements be documented in writing. Effective two-way communication between the group and component auditors is fundamental to an effective group audit. In the past, effective two-way communication has been challenging for auditors of governmental entities due to the numerous auditors involved, the competitive selection process, and various governance structures.

4.118 AU-C section 600 does not explicitly establish requirements for the component auditor in audits of group financial statements. However, paragraph .42 of AU-C section 600 requires the engagement team to request a component auditor to communicate certain matters (often provided for in a letter of instruction[21]) and to evaluate the component auditor's communication as well as the adequacy of their work. If effective two-way communication does not exist between the group engagement team and the component auditor, a risk exists that the group engagement team may not obtain sufficient appropriate audit evidence.

Subsequent Events

4.119 Group management is responsible for determining the effect, if any, subsequent events will have on the group financial statements through the date of the group auditor's report. This extends to subsequent events affecting group

[21] Appendix C, "Required and Additional Matters Included in the Group Engagement Team's Letter of Instruction," of AU-C section 600 provides such an example.

financial statements related to components that occur between the dates of the component financial information and the date the group financial statements are issued or available to be issued. This is particularly challenging for state and local governments considering the nature of their components (that is, a separate governance structure) which may limit the control that group management (primary government) has over the component. Additionally, there are often significant differences between the dates of the auditors' reports on the group and one or more of the components.

4.120 Under AU-C section 600, either the group engagement team or component auditors should perform subsequent events procedures through date of the group auditor's report. Often it will not be practical or possible based on legal or contractual relationships for the group auditor to perform subsequent event procedures directly at components. In these circumstances, the group auditor's overall responsibility may be satisfied by testing group management's process in identifying subsequent events at components, relying on procedures performed by the component auditor, or both. Early communication with group management regarding its responsibilities to identify events at components that occur between the dates of the component's financial information and the date group management evaluates subsequent events for purposes of the group financial statements may increase audit efficiency for the group engagement team.

4.121 The division of responsibilities between the group engagement team and the component auditor related to subsequent events may be agreed on by all parties and documented in order to avoid misunderstandings at a later date. In addition, the auditor of the group financial statements may expand or modify the engagement or management representation letters for both the components and the group as a result of the requirements of AU-C section 600 relative to subsequent events. Refer to paragraphs .40 and .59 of AU-C section 600 for more information about responsibilities for subsequent events in group audit engagements.

Other Audit Considerations

Subcontracting Arrangements

4.122 Because of expertise, contracting requirements or preferences, or other reasons, an auditor might participate in an audit on a subcontract basis with another auditor, for example, a minority-owned or small firm. Auditors participating in such an arrangement should establish an understanding of the services to be performed in writing, and may include the following:

- Client communication responsibilities, including general communications and communicating findings
- Determining the compensation of the parties
- Supervising the engagement
- Documenting the engagement and ownership of audit documentation
- Establishing review procedures
- If other auditors are responsible for the audit of a component, the group auditor should follow the guidance in AU-C section 600 (see paragraphs 4.95–.121).

Independence Requirements

4.123 AICPA members who are engaged to audit the financial statements of governmental entities in accordance with GAAS are required to be independent. In making judgments about whether they are independent, members should be guided by the "Independence Rule" (AICPA, *Professional Standards*, ET sec. 1.200.001) of the AICPA Code of Professional Conduct and its interpretations.[22] Members should use ET section 1.210.010, "Conceptual Framework for Independence" (AICPA, *Professional Standards*), when making decisions on independence matters that are not explicitly addressed by the AICPA Code of Professional Conduct. Among those interpretations, the "General Requirements for Performing Nonattest Services" interpretation (AICPA, *Professional Standards*, ET sec. 1.295.040) establishes requirements that members should meet to perform nonattest services for an attest client without impairing the auditor's independence with regard to that client. Those requirements are that (*a*) the member should not perform management functions or make management decisions for the attest client, (*b*) the client must agree to perform certain functions in connection with the engagement to perform nonattest services, including make all management decisions, perform all management functions, and accept responsibility for the results of the services, and (*c*) the member should establish and document in writing the auditor's understanding with the client certain matters, such as the objectives of the engagement and any limitations of the engagement. The "Nonattest Services" subtopic (AICPA, *Professional Standards*, ET sec. 1.295) provides examples of the types of nonattest services that would be considered to impair a member's independence. Members also should be guided by the definition of the term *client* in paragraph .03 of the "Definitions" section (AICPA, *Professional Standards*, ET sec. 0.400), which provides that AICPA members who are employed by state and local governments who meet certain criteria may be considered independent for purposes of auditing their employer governments.

4.124 The following additional independence requirements should be considered when providing nonattest services:

- Members will need to consider the cumulative effect providing multiple nonattest services may have on independence. Specifically, before agreeing to perform another nonattest service for an attest client, members will need to determine if the safeguards provided in the "General Requirements for Performing Nonattest Services" interpretation reduce the self-review and management participation threats to an acceptable level. In situations where the member determines that threats would not be reduced to an acceptable level by those safeguards, before providing an additional nonattest service the member will need to implement additional safeguards that would reduce threats to an acceptable level. However, the member is not required to consider the possible threats to independence created due to the provision of nonattest

[22] Some state boards of accountancy have independence requirements in addition to those of the AICPA. Also, for engagements conducted in accordance with *Government Auditing Standards*, auditors and audit organizations are subject to the AICPA Code of Professional Conduct as well as the additional independence requirements found in chapter 3 of *Government Auditing Standards*. The AICPA Audit Guide Government Auditing Standards *and Single Audits* discusses the independence requirements of *Government Auditing Standards*, including when the conceptual framework is used, considerations related to nonaudit services, and additional documentation requirements.

services by other network firms within the firm's network. This new requirement is outlined in the "Cumulative Effect on Independence When Providing Multiple Nonattest Services" interpretation (AICPA, *Professional Standards*, ET sec. 1.295.020).

In addition, activities such as financial statement preparation, cash-to-accrual conversions, and reconciliations are considered outside the scope of the attest engagement and, therefore, constitute a nonattest service (AICPA, *Professional Standards*, ET sec. 1.295.010.06). As such, when these services are provided they would be subject to the "General Requirements for Performing Nonattest Services" interpretation.

4.125 The "Entities Included in State and Local Government Financial Statements" interpretation (AICPA, *Professional Standards*, ET sec. 1.224.020) of the AICPA Code of Professional Conduct discusses the effect on an auditor's independence of relationships with entities included in governmental financial statements. The interpretation states that

- auditors issuing a report on the basic financial statements of the financial reporting entity must be independent of the financial reporting entity, as defined in the interpretation. However, where the primary auditor explicitly states reliance on other auditors reports thereon, independence is not required with respect to any major or nonmajor fund, internal service fund, fiduciary fund, or component unit or other entities disclosed in the financial statements. In addition, independence is not required with respect to an entity disclosed in the notes to the basic financial statements if the financial reporting entity is not financially accountable for the organization and the required disclosure does not include financial information. For example, a disclosure limited to the financial reporting entity's ability to appoint the governing board members of an organization would not require the auditor to be independent of that organization. However, auditors and their immediate family should not hold a key position with a major fund, nonmajor fund, internal service fund, fiduciary fund, or component unit of the financial reporting entity or other entity that should be disclosed in the notes to the basic financial statements.
- auditors who are auditing the financial statements of a major fund, nonmajor fund, internal service fund, fiduciary fund, or component unit of the financial reporting entity or an entity that should be disclosed in the notes to the basic financial statements of the financial reporting entity, but are not auditing the primary government, should be independent with respect to the financial statements being reported upon. Auditors are not required to be independent of the primary government or other funds or component units of the reporting entity or entities that should be disclosed in the notes to the basic financial statements. However, auditors and their immediate family should not hold a key position within the primary government.

4.126 Sometimes when a government audit agency performs an audit, there is a change in the administration of the audit agency (for example, as a result of an election). In some cases, the completion of the audit may fall within the term of the outgoing government auditor. Even though the majority of the audit procedures performed may fall within the predecessor auditor's term, the auditor in office when the determination that sufficient appropriate audit evidence has been obtained for the auditor to be able to issue the auditor report (which, under AU-C section 700), determines the date of the auditor's report) generally should sign the report because the auditor relies on the staff of the audit agency. That determination may occur after certain additional auditing procedures, for example, supervisory reviews and obtaining management and attorney representation letters, have been performed, which may not be until after the incoming government auditor takes office. (Chapter 15 discusses a similar situation involving the signing of the management representation letter following a change in administration.)

4.127 The "Indemnification of an Attest Client" interpretation (AICPA, *Professional Standards*, ET sec. 1.228.020) indicates that a member's independence would be impaired in an attestation engagement if, as a condition to being retained, the member (or the auditor's firm) was requested by the client or potential client to indemnify the client or potential client for damages, losses, or costs arising from lawsuits, claims, or settlements that relate, directly or indirectly, to client acts. Governments often include such clauses in requests for proposals for audit services and proposed audit contracts. Therefore, auditors should carefully review requests for proposals and proposed audit contracts for such clauses to ensure that they are not agreeing to such provisions.

Required Supplementary Information, Supplementary Information, and Other Information

4.128 As discussed in chapter 2, a government's basic financial statements always should be accompanied by MD&A and frequently may be accompanied by various types of other supporting information presented outside the basic financial statements. Information that GAAP requires accompany the basic financial statements is RSI, and GASB-established RSI includes, for example, MD&A, certain pension funding information, and OPEB information, information about infrastructure assets accounted for using the modified approach, and budgetary comparison information. On the other hand, "GASB defined" SI is information that GAAP does not require accompany the basic financial statements. Governments provide "GASB defined" SI voluntarily to supplement and expand upon the basic financial statements. Some governments provide "GASB defined" SI as part of a CAFR (as further discussed in chapter 2 and paragraph 4.25) such as the introductory section (including the letter of transmittal), the combining and individual nonmajor fund financial statements and schedules, and the statistical section. According to AU-C section 730, RSI differs from "GASB defined" SI because RSI is considered an essential part of financial reporting and because there are authoritative guidelines for measuring and presenting RSI.

4.129 "GASB defined" SI may be either OI as defined in AU-C section 720 or SI as defined in AU-C section 725. The determination of whether the auditor is within the scope of AU-C section 720 or AU-C section 725 is dependent upon both the type of information and the engagement. If certain information meets the definition of SI in AU-C section 725 and the auditor is engaged to report on whether it is fairly stated, in all material respects, in relation to the financial statements as a whole, then AU-C section 725 applies. Otherwise, the information is considered OI, and the auditor's responsibility is described in AU-C section 720. Examples of information that is typically considered OI under AU-C section 720 include the introductory section (including the letter of transmittal) and the statistical section of a CAFR (that is, in practice auditors are not typically engaged to provide an "in relation to" opinion on this information). Information that is typically considered SI include the combining and individual nonmajor fund financial statements and schedules of a CAFR (that is, in practice auditors are often engaged to provide an "in relation to" opinion on this information).[23]

4.130 Unless the auditor is engaged to audit information that accompanies the basic financial statements as discussed in paragraph 4.131,[24] the procedures that an auditor applies to that information depend on whether the information is RSI, SI, or OI. Paragraphs 4.131–.136 discuss the definitions of and the required audit procedures relating to RSI, SI, and OI. In addition, chapter 18, "Auditor Involvement With Municipal Securities Filings," discusses the auditor's responsibilities for information that accompanies the basic financial statements in official statements. Chapter 16 discusses auditor reporting on RSI, SI, and OI.

Audit Scope Includes Required Supplementary Information or Supplementary Information

4.131 The auditor may be engaged to audit either or both RSI and "GASB defined" SI, that is, express an opinion whether the information is fairly presented, in all material respects, in accordance with GAAP. For example, as discussed in chapter 2, state and local governments may elect to report the required budgetary comparison information in a budgetary comparison statement as part of the basic financial statements, rather than as RSI. If the government makes this election, under AU-C section 700, the auditor should perform procedures considered sufficient to express an opinion on whether the budgetary comparison information financial statement is fairly stated, in all material respects, in accordance with GAAP. In this situation, the government has satisfied the GASB requirement for inclusion of the information; however, the nature of the required information has changed from RSI to a basic financial statement. The auditor may also be engaged under AU-C section 805, *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement* (AICPA, *Professional Standards*), to express an opinion regarding whether combining and individual nonmajor fund financial statements presented as "GASB defined" SI are fairly stated, in all material respects, in accordance with GAAP.

4.132 When engaged to audit RSI or "GASB defined" SI, the auditor should plan and perform adequate procedures responsive to the assessed risks of material misstatement and evaluate the results of those procedures to support developing an opinion on the information or to disclaim an opinion. The auditor makes materiality determinations and establishes opinion units for planning,

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[23] There are some "certification" programs that may require either a full opinion or "in relation to" opinion on combining and individual fund financial statements and schedules. Thus, in such scenarios this information may be treated as SI for auditing purposes. Absent such a requirement, the information would be treated as OI.

[24] Being *engaged to audit* information that accompanies the basic financial statements means being engaged to express an opinion whether that accompanying information is fairly presented, in all material respects, in accordance with generally accepted accounting principles. Unless the auditor is engaged to audit the accompanying information, the information is considered *unaudited,* even though GAAS require the auditor to perform specific procedures and to report on the information as discussed in this section and chapter 16.

performing, evaluating the results of, and reporting on the results of the audit depending on the terms of the engagement. For example, if the engagement terms provide for the audit of each fund presented in combining and individual nonmajor fund financial statements, the auditor should consider each fund to be a separate opinion unit.

Required Supplementary Information

4.133 AU-C section 730 addresses the auditor's responsibility with respect to RSI. AU-C section 730 defines RSI as information a designated accounting standards setter[25] (that is, GASB, for purposes of this guide) requires to accompany an entity's basic financial statements. RSI is not part of the basic financial statements; however, GASB considers the information an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. Additionally, authoritative guidelines for the methods of measurement and presentation of the information have been established by GASB regarding RSI. In the absence of any separate requirement in the particular circumstances of the audit engagement, the audit opinions on the various opinion units contained in the basic financial statements do not cover RSI.[26] The auditor should apply the following limited procedures to the RSI (unless the auditor is engaged to audit the RSI as discussed in paragraph 4.131), as required by paragraph .05 of AU-C section 730:

- Inquire of management about the methods of preparing the information, including (*a*) whether it is measured and presented in accordance with prescribed guidelines, (*b*) whether methods of measurement or presentation have been changed from those used in the prior period and the reasons for any such changes, and (*c*) whether there were any significant assumptions or interpretations underlying the measurement or presentation of the information.
- Compare the information for consistency with (*a*) management's responses to the foregoing inquiries, (*b*) the basic financial statements, and (*c*) other knowledge obtained during the audit of the basic financial statements.
- Obtain written representations from management (*a*) that it acknowledges its responsibility for the RSI; (*b*) about whether the RSI is measured and presented in accordance with prescribed guidelines; (*c*) about whether the methods of measurement or presentation have changed from those used in the prior period and, if so, the reasons for such changes; and, (*d*) about any significant assumptions or interpretations underlying the measurement or presentation of the RSI. See chapter 16 for additional requirements and guidance on management representations.

If the auditor is unable to complete these procedures, the auditor should consider whether management contributed to the auditor's inability to complete the procedures. If the auditor concludes the inability to complete the procedures

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[25] FASB, GASB, International Accounting Standards Setting Board, and Federal Accounting Standards Advisory Board are accounting standard setters currently recognized in professional standards.

[26] Unless the auditor is engaged to audit the RSI as further described in paragraphs 4.132–.133, RSI is considered *unaudited*, even though GAAS require the auditor to perform specific procedures and to report on the information as discussed in this section and in chapter 16.

is due to significant difficulties encountered in dealing with management, the auditor should inform those charged with governance. See chapter 15 for reporting responsibilities in these circumstances.

Supplementary Information

4.134 For purposes of GAAS, SI is defined in AU-C section 725 as information presented outside the basic financial statements, excluding RSI that is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. Such information may be presented in a document containing the audited financial statements or separate from the financial statements. As further discussed in chapter 16, an opinion on whether SI is fairly stated in all material respects is made in relation to the basic financial statements as a whole, not in relation to individual opinion units (see a description of the opinion units in a governmental audit in paragraph 4.67). Chapter 16 also discusses the auditor's responsibilities when the auditor concludes, on the basis of the procedures performed, that the SI is materially misstated in relation to the basic financial statements as a whole.

4.135 In order to opine on whether SI is fairly stated, in all material respects, in relation to the financial statements as a whole, the auditor should determine whether all of the following conditions are met as required by paragraph .05 of AU-C section 725:

- The SI was derived from, and relates directly to, the underlying accounting and other records used to prepare the financial statements;
- The SI relates to the same period as the financial statements;
- The financial statements were audited, and the auditor served as the group auditor in that engagement;
- Neither an adverse opinion or a disclaimer of opinion was issued on the financial statements; and
- The SI will accompany the entity's audited financial statements, or such audited financial statements will be made readily available[27] by the entity.

4.136 The auditor's responsibilities with regard to SI for which the auditor is providing an "in relation to" opinion[28] are provided in AU-C section 725. The auditor should apply the following limited procedures to the SI, as required by paragraphs .06–.07 of AU-C section 725:

- Obtain the agreement of management that it acknowledges and understands its responsibility
  - — for the preparation of the SI in accordance with the applicable criteria
  - — to provide the auditor with the following written representations

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[27] Audited financial statements are deemed to be readily available if a third party user can obtain the audited financial statements without any further action by the entity (for example, posted on the entity's website but not being available upon request).

[28] Unless the auditor is engaged to audit the SI as further described in paragraphs 4.134–.136, SI is considered *unaudited*, even though GAAS require the auditor to perform specific procedures, as discussed in this section of this chapter, and to report on the information, as discussed in chapter 16.

        - that it acknowledges its responsibility for the presentation of the SI in accordance with the applicable criteria;
        - that it believes the SI, including its form and content, is fairly presented in accordance with the applicable criteria;
        - that the methods of measurement or presentation have not changed from those used in the prior period or, if the methods of measurement or presentation have changed, the reasons for such changes;
        - about any significant assumptions or interpretations underlying the measurement or presentation of the SI; and
        - that when the SI is not presented with the audited financial statements, management will make the audited financial statements readily available to the intended users of the SI no later than the date of issuance by the entity of the SI and the auditor's report thereon.
    - — to include the auditor's report on the SI in any document containing the SI and that indicates the auditor reported on such SI.
    - — to present the SI with the audited financial statements or, if the SI will not be presented with the audited financial statements, to make the audited financial statements readily available to the intended users of the SI no later than the date of issuance by the entity of the SI and the auditor's report thereon.

- In addition to the procedures performed during the audit of the financial statements, in order to opine on whether the SI is fairly stated, in all material respects, in relation to the financial statements as a whole, the auditor should perform the following procedures using materiality at a level that represents the entire governmental entity:
    - — Inquire of management about the purpose of the SI and the criteria used by management to prepare the SI, such as an applicable financial reporting framework, criteria established by a regulator, contractual agreement, or other requirement;
    - — Evaluate whether the form and content of the SI complies with the applicable criteria;
    - — Obtain an understanding about the methods of preparing the SI and determine whether the methods of preparing the SI have changed from those used in the prior period and, if the methods have changed, the reasons for such changes;
    - — Compare and reconcile the SI to the underlying accounting and other records used in preparing the financial statements or to the financial statements themselves;

— Inquire of management about any significant assumptions or interpretations underlying the measurement or presentation of the SI;

— Evaluate the appropriateness and completeness of the SI, considering the results of the procedures performed and other knowledge obtained during the audit of the financial statements; and

— Obtain the preceding noted written representations from management.

Other Information

4.137 If the auditor is not engaged to issue an "in relation to" opinion under AU-C section 725 on the "GASB defined" SI, then AU-C section 720 applies. OI, as defined by AU-C section 720, is financial and nonfinancial information (other than the financial statements and the auditor's report thereon) that is included in a document containing audited financial statements and the auditor's report thereon, excluding RSI. In a government environment, OI typically includes information in the introductory and statistical sections of a CAFR. The objective of the auditor with respect to OI is to respond appropriately when the auditor becomes aware that documents containing audited financial statements and the auditor's report thereon include OI that could undermine the credibility of those financial statements and the auditor's report. The auditor should apply the following limited procedures to the OI, as required by paragraphs .06–.18 of AU-C section 720:

- Read the OI of which the auditor is aware in order to identify material inconsistencies, if any, with the audited financial statements.
- Make appropriate arrangements with management or those charged with governance to obtain the OI prior to the report release date. If it is not possible to obtain all of the OI prior to the report release date, the auditor should read such OI as soon as practicable.
- Communicate with those charged with governance the auditor's responsibility with respect to the OI, any procedures performed relating to the OI, and the results.
- When the auditor identifies a material inconsistency in the OI that requires revision of the audited basic financial statements, the auditor requirements depend upon when the material inconsistency was identified and management's actions:

  — If identified prior to the report release date and management makes the appropriate revision, the auditor's opinion on the financial statements would not be impacted.

  — If identified prior to the report release date and management refuses to make the appropriate revision, the auditor should modify the auditor's financial statement opinion in accordance with AU-C section 700.

  — If identified subsequent to the report release date, the auditor should apply the relevant requirements in AU-C section 560, *Subsequent Events and Subsequently Discovered Facts* (AICPA, *Professional Standards*).

- When the auditor identifies a material inconsistency in OI that requires revision of the OI, the auditor requirements depend upon when the material inconsistency was identified and management's actions. If a material inconsistency is identified prior to the report release date and management refuses to make the appropriate revision, the auditor should communicate this matter to those charged with governance and
    - — include in the auditor's report on the audited financial statements an other-matter paragraph describing the material inconsistency, in accordance with paragraph .12 of AU-C section 720;
    - — withhold the auditor's report; or
    - — when withdrawal is possible under applicable law or regulation, withdraw from the engagement. (In audits of governmental entities, withdrawal from the engagement or withholding the auditor's report may not be options. In such cases, the auditor may issue a report to those charged with governance and the appropriate statutory body, if applicable, giving details of the inconsistency.)
    - — when the auditor identifies a material inconsistency in the OI subsequent to the report release date and management agrees to make the appropriate revision, the auditor should carry out the procedures necessary under the circumstances.
- If a material inconsistency is identified subsequent to the report release date and management refuses to make the appropriate revision, the auditor should notify those charged with governance of the auditor's concerns regarding the OI and take any further appropriate action, such as obtaining advice from the auditor's legal counsel.
- If the auditor becomes aware of an apparent material misstatement of fact in the OI, the auditor should discuss the matter with management. After such discussions, if the auditor still considers that there is an apparent material misstatement of fact, the auditor should request management to consult with a qualified third party, such as the government's legal counsel, and the auditor should consider the advice received by the government in determining whether such matter is a material misstatement of fact. When the auditor concludes there is a material misstatement of fact that management refuses to correct, the auditor should notify those charged with governance of the auditor's concerns regarding the OI and take any further appropriate action.

4.138

Appendix A—Consideration of Fraud in a Financial Statement Audit

A-1 AU-C section 240, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*), is the primary source of authoritative guidance about an auditor's responsibilities concerning the consideration of fraud in a financial statement audit. AU-C section 240 establishes 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 as a whole are free from material misstatement, whether due to fraud or error as stated in paragraph .12 of AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*). This responsibility should be applied based on opinion units. (See the discussion of the concept of opinion units in planning, performing, evaluating the results of, and reporting on governmental audits in this chapter and chapter 15, "Concluding the Audit," and chapter 16, "Audit Reporting.")

A-2 The following two types of misstatements are relevant to the auditor's consideration of fraud in a financial statement audit:

- Misstatements arising from fraudulent financial reporting
- Misstatements arising from misappropriation of assets

A-3 Three conditions generally are present when fraud occurs. First, management or other employees have an *incentive* or are under *pressure*, which provides a reason to commit fraud. Second, circumstances exist—for example, the absence of controls, ineffective controls, or the ability of management to override controls—that provide an *opportunity* for a fraud to be perpetrated. Third, those involved are able to *rationalize* committing a fraudulent act.

The Importance of Exercising Professional Skepticism

A-4 Because of the characteristics of fraud, the auditor's exercise of professional skepticism is important when considering the risk of material misstatement due to fraud. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor should maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the government's management and those charged with governance. Furthermore, professional skepticism requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred.

Discussion Among Engagement Personnel Regarding the Risks of Material Misstatement Due to Fraud[1]

A-5 Members of the audit team should discuss the potential for material misstatement due to fraud in accordance with the requirements of paragraph .15

[1] The brainstorming session to discuss the entity's susceptibility to material misstatements due to fraud could be held concurrently with the brainstorming session required under AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), to discuss the potential of the risks of material misstatement.

of AU-C section 240. The discussion among the audit team members about the susceptibility of the entity's financial statements to material misstatement due to fraud should occur setting aside beliefs that the engagement team members may have that management and those charged with governance are honest and have integrity, and should, in particular, also address

- a consideration of the known external and internal factors affecting the entity that might create incentives/pressures for management or others to commit fraud, provide the opportunity for fraud to be perpetrated, and indicate a culture or environment that enables management or others to rationalize committing fraud;
- the risk of management override of controls;
- consideration of circumstances that might be indicative of earnings management or manipulation of other financial measures and the practices that might be followed by management to manage earnings or other financial measures that could lead to fraudulent reporting;
- the importance of maintaining professional skepticism throughout the audit regarding the potential for material misstatement due to fraud; and
- how the auditor might respond to the susceptibility of the entity's financial statements to material misstatements due to fraud.

Communication among the audit team members about the risks of material misstatement due to fraud also should continue throughout the audit, particularly upon discovery of new facts.

A-6 The following are potential fraud risk factors specific to or significant for state and local governments. The risk factors generally relate to misstatements arising from fraudulent financial reporting.[2] This listing does not include all government-specific fraud factors, and does not list many fraud factors that might exist in any entity, governmental or nongovernmental (such as adverse relationships between the entity and employees with access to cash or other assets susceptible to theft, and deficient internal control resulting from inadequate monitoring).

A. *Incentives/Pressures*

- There are or are expected to be laws or regulations that limit resources.
- The entity is subject to unfunded mandates from other governments.
- The entity is subject to public pressure to provide more services with fewer dollars.
- There have been or are expected to be funding cuts from grantors and other resource providers.
- The entity has major taxpayers with declining financial condition or position.
- The entity has a declining property or other tax base.
- The entity is experiencing a declining demand for services.

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[2] Items marked (*) relate to misstatements arising from misappropriation of assets.

- The entity's investment values have been negatively affected by the market.
- The entity uses high-risk or exotic investments to maintain or increase investment income.
- The entity has a significant need to obtain debt financing.
- The entity uses complex or "innovative" financing mechanisms.
- The entity is unable to generate sufficient cash flows to cover expenditures.
- The entity is experiencing rapid growth, unusual budget growth, or unusual budget surpluses, especially compared to other, similar entities.
- There is substantial political pressure on management creating an undue concern about reporting positive financial accomplishments.
- Investment analysts, institutional investors, significant creditors, donors, or other external parties have unduly aggressive or unrealistic expectations about financial position or performance, budget results, or program achievements. (Those expectations might have been created by management in, for example, overly optimistic press releases or annual report messages.)
- The entity's financial position or performance is close to violating debt covenants.
- Net position is a deficit, while fund balances are positive.
- The entity is having difficulty developing a balanced budget for the next fiscal year due to either anticipated revenue shortfalls or projected excessive expenditures.
- Management expects adverse consequences on significant pending transactions, such as a grant or contract award or modification, if it reports poor financial or program performance.

B. ***Opportunities***

- Those charged with governance are inexperienced or unqualified.
- Those charged with governance accept management's recommendations and actions without inquiry or debate.
- The entity is subject to complex or frequently changing accounting requirements.
- The entity has financially significant transactions for which there are no or unclear generally accepted accounting principles.
- The entity makes excessive use of separate funds, internal service funds, or interfund and internal activity.
- There is a high incidence of patronage employment in positions with significant authority or responsibilities.
- There have been or are expected to be changes in entity management or governing body composition.
- The entity lacks a formal budgeting or planning process.
- The budget is not prepared by the appropriate level of management or is prepared without the input of employees who have a thorough understanding of the budgetary aspects of the entity's activities.

- Budgets are modified after year end to reflect actual results.
- There is uncontrolled access to cash or cash equivalents, such as parking meter receipts and benefit vouchers.(*)
- The entity does not require personnel to provide appropriate documentation for regular time, overtime, or vacation and sick leave time taken.(*)
- The entity awards financially significant contracts without competitive bids, or without due consideration of vendor qualifications.(*)
- The entity gives departmental or agency directors authority to expend certain monies outside of the budgetary process.(*)
- Assets that do not qualify for capitalization for financial reporting purposes are not being marked with identification tags, listed on asset inventory records, or subject to periodic physical inspections or other physical safeguards.(*)

C. ***Attitude/Rationalization***

- There is an excessive interest by management in meeting or exceeding budgetary targets; maintaining a predetermined level of fund balance, or net position; meeting debt covenant requirements; or maintaining or improving bond ratings.
- Those charged with governance or management do not support public accountability or programmatic efficiencies.
- Those charged with governance or management display a significant disregard for regulatory, legal, or oversight requirements or for federal, state or other regulatory authorities.
- Management has not engaged reputable professional third parties appropriate to the entity's needs, such as attorneys, investment bankers, actuaries, appraisers, financial advisers, and bond counsel.
- Management displays an attitude of (or there is analytical evidence of) the view that funds must be spent on a "use or lose" basis in order to sustain future funding levels.
- Management fails to effectively follow up on questions about financial position, financial performance, or budget variances.

Obtaining the Information Needed to Identify the Risks of Material Misstatement Due to Fraud

A-7 AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), establishes standards and provides guidance about how the auditor obtains an understanding of the entity and its environment, including its internal control for the purpose of assessing the risks of material misstatement. In performing that work, information may come to the auditor's attention that should be considered in identifying risks of material misstatement due to fraud. As part of this work, the auditor should perform the following procedures to obtain information that is used to identify the risks of material misstatement due to fraud (as described in paragraphs .17–.23 of AU-C section 240):

a. Make inquiries of management, those charged with governance (unless all are involved in managing the entity), and others within the entity[3] to obtain their views about the risks of fraud and how they are addressed and whether they have knowledge of any actual, suspected, or alleged fraud affecting the government. (See paragraphs .17–.21 of AU-C section 240.)

b. Evaluate any unusual or unexpected relationships that have been identified in performing analytical procedures as part of risk assessment procedures. (See paragraph .22 of AU-C section 240.)

c. Consider whether one or more fraud risk factors exist. (See paragraphs .24 and .A28–.A31 and the appendix of AU-C section 240.)

d. Consider other information that may be helpful in the identification of risks of material misstatement due to fraud. (See paragraph .23 of AU-C section 240.)

A-8 In performing risk assessment procedures, the auditor also should perform analytical procedures relating to revenue with the objective of identifying unusual or unexpected relationships involving revenue accounts that may indicate a material misstatement due to fraudulent financial reporting.[4,5] For example, in state and local government, the following unusual or unexpected relationships relating to revenue may indicate a material misstatement due to fraud:

- Actual revenues at significant variance from originally budgeted revenues
- Actual revenues at significant variance from prior-period actual revenues, without similar changes in the revenue base or rates
- A significant increase in actual revenues over those of the prior period that is just enough to keep the government from reporting annual or accumulated fund balance, or net position deficit, or from violating debt covenants
- Large "miscellaneous" or "one-shot" revenues
- Resources received in advance and deferred inflows of resources at significant variance from the prior-period

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[3] *Others within the entity* include the audit committee or others with equivalent authority and responsibility. If a government does not have an audit committee, *others with equivalent authority and responsibility* may include the governing board, such as a city council or a school board. In AU-C section 240, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*), and the remainder of this appendix, the term *audit committee* encompasses others with authority and responsibility equivalent to an audit committee.

[4] In government, the reference to *revenues* would encompass all resource inflows, even if reported as other financing sources, additions, special and extraordinary items, and so forth.

[5] Some auditors believe that, in government, there is a greater risk of material misstatement due to fraudulent financial reporting arising from misstated expenses or expenditures than from misstated revenues. That is, they believe that the nature of governmental transactions and governmental financial reporting leads to a higher likelihood that expenses or expenditures (rather than revenues) will be misstated. For example, a government's management might intentionally misstate expenses or expenditures for compensated absences, claims and judgments, or postemployment benefits other than pensions. AU-C section 240 provides requirements and guidance to address the risks of material misstatement of expenses or expenditures. However, even if the auditor perceives greater risks relating to misstated expenses or expenditures than to misstated revenues, paragraph .26 of AU-C section 240 continues to require the auditor ordinarily to presume a risk of material misstatement due to fraud relating to revenue recognition. (See paragraph A-12.) If the auditor does not identify improper revenue recognition as a risk of material misstatement due to fraud in a particular circumstance, paragraph .46 of AU-C section 240 requires the auditor to include the reasons supporting that conclusion in the audit documentation.

- Revenue from sales of assets without a similar reduction in the asset accounts
- Investment income that is contrary to market conditions
- Expenditure-driven grant revenue without offsetting grant expenditures

Considering Fraud Risk Factors

A-9 As indicated in paragraph A-7*c*, the auditor may identify events or conditions that indicate incentives/pressures to perpetrate fraud, opportunities to carry out the fraud, or attitudes/rationalizations to justify a fraudulent action. Such events or conditions are referred to as *fraud risk factors*. Fraud risk factors do not necessarily indicate the existence of fraud; however, they often are present in circumstances where fraud exists.

A-10 AU-C section 240 provides fraud risk factor examples that have been written to apply to most enterprises. Paragraph A-6 lists examples of state and local government-specific fraud risk factors and other conditions that may indicate the presence of a material misstatement due to fraud. Remember that fraud risk factors are only one of several sources of information an auditor considers when identifying and assessing risks of material misstatement due to fraud.

Identifying Risks That May Result in a Material Misstatement Due to Fraud[6]

A-11 In identifying risks of material misstatement due to fraud, it is helpful for the auditor to consider the information that has been gathered in accordance with the requirements of paragraphs .25–.27 of AU-C section 240. The auditor's identification of fraud risks may be influenced by characteristics such as the size, complexity, and ownership attributes of the entity. In addition, the auditor should evaluate whether identified risks of material misstatement due to fraud can be related to specific financial-statement account balances or classes of transactions and related assertions, or whether they relate more pervasively to the financial statements as a whole. Certain accounts, classes of transactions, and assertions that have high inherent risk because they involve a high degree of management judgment and subjectivity also may present risks of material misstatement due to fraud because they are susceptible to manipulation by management. In state and local government, such accounts, classes of transactions, and assertions may include, but not necessarily be limited to, the following:

- The valuation of investments for which there is no market-established fair value
- The valuation of receivable allowances
- The valuation of excessive or obsolete supplies inventory
- Long-outstanding interfund receivables or payables, which may not represent valid rights and obligations
- The valuation of the recourse liability for receivables sold with recourse

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[6] AU-C section 315 requires the auditor to identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures. See paragraph .26 of AU-C section 315.

- The valuation of liabilities for compensated absences, claims and judgments (including risk financing liabilities), termination benefits, pension benefits, postemployment benefits other than pensions (OPEB), pollution remediation liabilities, and landfill closure and postclosure care costs
- The amount at which a net pension liability (asset) or net OPEB obligation (asset) is reported or disclosed, respectively
- The existence of restrictions on net position
- The classification of revenues as program versus general
- The classification of interfund and internal activity and balances, including elimination of allocated expenses
- Depreciation on capital assets, where applicable, especially those with long useful lives
- The classification of capital assets as land versus land improvements versus infrastructure assets, thus affecting classification and allocation of costs
- The status of specific conditions related to internally generated intangible assets that could affect the classification of such as capital assets versus expenses

Improper Revenue Recognition

A-12 Material misstatements due to fraudulent financial reporting often result from an overstatement of revenues (for example, through premature revenue recognition or recording fictitious revenues) or an understatement of revenues (for example, through improperly shifting revenues to a later period).[7] Therefore, the auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition (See paragraphs .26 and .A33–.A35 of AU-C section 240.) For example, a state or local government's management might intentionally

- recognize significant revenues on a cash basis, rather than on a modified accrual or accrual basis.
- overstate or understate the allowance for uncollectible receivables.
- delay recognition of revenue for protested taxes until the protest has run its course.
- net revenues against expenses or expenditures when no right of offset exists.
- fail to net revenue against expenses or expenditures, for example, for insurance recoveries received in the same year as an impairment loss.
- recognize revenue from derived taxes based on cash receipt rather than the underlying economic event.
- recognize revenue from government-mandated or voluntary nonexchange transactions without proper consideration for the eligibility requirements.
- recognize revenue, for example, for a legal judgment, before the amount is realizable.

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[7] See footnote 5 in this appendix.

Risk of Management Override

A-13 Even if specific risks of material misstatement due to fraud are not identified by the auditor, there is a possibility that management override of controls could occur, and accordingly, the auditor should address that risk (see paragraph .31 of AU-C section 240) apart from any conclusions regarding the existence of more specifically identifiable risks. Specifically, the procedures described in paragraph .32 of AU-C section 240 should be performed to further address the risk of management override of controls. These procedures include (1) testing journal entries and other adjustments for evidence of possible material misstatement due to fraud, (2) reviewing accounting estimates for biases that could result in material misstatement due to fraud, and (3) evaluating the business rationale for significant unusual transactions.

Key Estimates

A-14 In state and local government, key estimates involve investments with no market-established fair value or with permanent impairments, derivative transactions, uncollectible taxes receivable, the useful lives of capital assets that are depreciated, obligations for compensated absences, claims and judgments, termination benefits, landfill closure and postclosure care costs, pension benefits, postemployment benefits other than pensions and pollution remediation obligations.

Assessing the Identified Risks After Taking Into Account an Evaluation of the Entity's Programs and Controls That Address the Risks

A-15 Paragraphs .27 and .A36–.A37 of AU-C section 240 provide requirements and guidance concerning an entity's programs and controls that address identified risks of material misstatement due to fraud. Examples of programs and controls that auditors might find in state and local government include

- public disclosure of the entity's code of conduct.
- a competitive bidding process that rewards potential vendors that have fraud prevention and detection programs.
- a toll-free tip line for the public and employees to report suspected fraud.
- a process for checking whether job applicants have arrest records and for making periodic checks to see whether current personnel have arrest records.
- requirements that, periodically, employees and governing body officials disclose conflicts of interest and other exceptions to the code of conduct.
- periodic and random reviews by a certified fraud examiner.
- termination of employees found to have committed fraud.

A-16 The auditor should consider whether such programs and controls mitigate the identified risks of material misstatement due to fraud or whether specific control deficiencies exacerbate the risks. After the auditor has evaluated whether the entity's programs and controls have been suitably designed and placed in operation, the auditor should assess these risks taking into account that evaluation. This assessment should be considered when developing the auditor's response to the identified risks of material misstatement due to fraud.

Responding to the Results of the Assessment[8]

A-17 Paragraphs .28–.33 of AU-C section 240 provide requirements and guidance about an auditor's response to the results of the assessment of the risks of material misstatement due to fraud. The auditor responds to risks of material misstatement due to fraud in the following three ways:

a. A response that has an overall effect on how the audit is conducted—that is, a response involving more general considerations apart from the specific procedures otherwise planned (see paragraph .28–.29 of AU-C section 240).

b. A response to identified risks involving the nature, timing, and extent of the auditing procedures to be performed (see paragraph .30 of AU-C section 240). For example, in state and local government, the auditor might

  i. confirm transaction details with other governments (for example, for grants and tax collections) pertaining to year-end cut-offs.

  ii. perform additional inquiries and other procedures on the collectibility of interfund receivables, particularly large, continuing balances.

  iii. select larger sample sizes when examining write-offs of uncollectible taxes and other receivables.

  iv. perform detailed analysis of investment income by type of investment and time period.

  v. use firm or independent specialists to recalculate certain estimates, such as liabilities for pollution remediation obligations and landfill closure and postclosure care costs.

  vi. confirm compensated absences balances with employees.

  vii. observe capital assets that do not qualify for capitalization for financial reporting purposes.

  viii. scan accounting entries for unusual items.

  ix. count cash collections on a surprise basis during the year.

c. A response involving the performance of certain procedures to further address the risk of material misstatement due to fraud involving management override of controls, given the unpredictable ways in which such override could occur (see paragraph .31–.32 of AU-C section 240).

Evaluating Audit Evidence

A-18 Paragraphs .34–.37 of AU-C section 240 provide requirements and guidance for evaluating audit evidence. The auditor should evaluate whether analytical procedures that were performed as substantive tests or when forming an overall conclusion indicate a previously unrecognized risk of material misstatement due to fraud. Vague or implausible responses throughout the audit

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[8] AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), requires the auditor to evaluate overall responses and design and perform further audit procedures to respond to the assessed risks of material misstatement at the financial statement and relevant assertion levels in a financial statement audit. See paragraphs .05–.06 of AU-C section 330.

to inquiries about analytical relationships or responses that have produced evidence that is inconsistent with other evidential matter accumulated during the audit may indicate that the financial statements may contain a material misstatement resulting from fraud.

A-19 At or near the completion of fieldwork, the auditor should evaluate whether the accumulated results of auditing procedures and other observations affect the assessment of the risks of material misstatement due to fraud made earlier in the audit. As part of this evaluation, the auditor with final responsibility for the audit should ascertain that there has been appropriate communication with the other audit team members throughout the audit regarding information or conditions indicative of risks of material misstatement due to fraud.

Responding to Misstatements That May Be the Result of Fraud

A-20 When audit test results identify misstatements in the financial statements, the auditor should consider whether such misstatements may be indicative of fraud. See paragraphs .34–.37 of AU-C section 240 for requirements and guidance about an auditor's response to misstatements that may be the result of fraud. If the auditor believes that misstatements are or may be the result of fraud, but the effect of the misstatements is not material to the financial statements of the affected opinion unit, the auditor nevertheless should evaluate the implications, especially those dealing with the organizational position of the person(s) involved.

A-21 If the auditor believes that the misstatement is or may be the result of fraud, and either has determined that the effect could be material to the financial statements of the affected opinion unit or has been unable to evaluate whether the effect is material, the auditor should

a. attempt to obtain additional audit evidence to determine whether material fraud has occurred or is likely to have occurred, and, if so, its effect on the financial statements and the auditor's report thereon.[9]

b. consider the implications for other aspects of the audit (see paragraph .37 of AU-C section 240).

c. communicate the matter on a timely basis to the appropriate level of management, that is at least one level above those involved, and with senior management and the audit committee, to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities[10] (see paragraph .39 of AU-C section 240).

d. if appropriate, suggest that the client consult with legal counsel.

A-22 The auditor's consideration of the risks of material misstatement and the results of audit tests may indicate such a significant risk of material misstatement due to fraud that the auditor should consider withdrawing from the engagement, as permitted by applicable law or regulation, and communicating

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[9] See AU-C section 700, *Forming an Opinion and Reporting on Financial Statements* (AICPA, *Professional Standards*), and AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report* (AICPA, *Professional Standards*), for guidance on auditors' reports issued in connection with audits of financial statements.

[10] If the auditor believes senior management may be involved, discussion of the matter directly with the audit committee may be appropriate.

the reasons for withdrawal to the audit committee or others with equivalent authority and responsibility. The auditor may wish to consult with legal counsel when considering withdrawal from an engagement.

Communicating About Possible Fraud to Management, the Audit Committee, and Others

A-23 Whenever the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. See paragraphs .39–.42 of AU-C section 240 for further requirements and guidance about communications with management, the audit committee, and others.[11]

Documenting the Auditor's Consideration of Fraud

A-24 Paragraphs .43–.44 of AU-C section 240 requires certain items and events to be documented by the auditor. Auditors should comply with those requirements.

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[11] Title 2 U.S. *Code of Federal Regulations* Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards*, also contains requirements for reporting fraud and material abuse. See the AICPA Audit Guide Government Auditing Standards *and Single Audits*.

Chapter 5

Investments, Certain Equity Interests, and Derivatives

5.01 This chapter addresses accounting and financial reporting standards that apply to investments, certain equity interests, and derivatives. The chapter includes the following sections:

- Part I—Accounting, Financial Reporting, and Auditing Considerations for Investments and Certain Equity Interests
- Part II—Accounting, Financial Reporting, and Auditing Considerations for Derivative Instruments

5.02 GASB Statement No. 72, *Fair Value Measurement and Application*, describes how fair value should be defined and measured, what assets and liabilities should be measured at fair value, and what information about fair value should be reported in the notes to the financial statements. Chapter 2, "Financial Reporting," discusses measurement principles—including valuation techniques, inputs to valuation, and the fair value hierarchy. This chapter discusses the application of fair value to investments and related disclosures.

5.03 GASB Statement No. 72, as amended, applies to investments and derivatives. However, for purposes of this chapter, investments are discussed separately from derivatives.

Part I—Accounting, Financial Reporting, and Auditing Considerations for Investments and Certain Equity Interests

5.04 Part I of this chapter discusses the accounting, financial reporting and auditing considerations for investments. GASB Statement No. 72 defines an investment as "a security or other asset that (*a*) a government holds primarily for the purpose of income or profit and (*b*) has present service capacity based solely on its ability to generate cash or to be sold to generate cash." Paragraphs 65–68 of GASB Statement No. 72 provide further guidance on the elements included in the definition of an investment. For example, if a university holds student loans as part of a governmental program to encourage higher education, the present service capacity of the loans is to provide a service that allows students to obtain an education. Accordingly, the present service capacity would not be based solely on the loan's ability to generate cash, and the loans would not meet the definition of an investment. In accordance with paragraph 68 of GASB Statement No. 72, the determination of whether an asset meets the definition of an investment is made at acquisition. Once the government determines whether the asset is an investment or another type of asset, the classification should be retained for financial reporting purposes, even if the government's usage of the asset changes over time.

5.05 Part I of this chapter also discusses the accounting, financial reporting, and auditing considerations for equity interests in common stock that do not meet the definition of an investment but that otherwise meet the criteria for applying the equity method in paragraphs 205–208 of GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*.

Nature of Transactions

Compliance Requirements and Deposit and Investment Policies

5.06 Governments usually have extensive legal and contractual provisions relating to investments and investment-related transactions that often differ for different funds and different objectives (like risk management versus investment). Those requirements usually involve the types and terms of investments and investment-related transactions a government may use (see paragraphs 5.07–.08), the counterparties with which it may conduct business, and the collateral it should obtain on depository accounts (see paragraph 5.09). Compliance requirements also arise from IRC and U.S. Treasury regulations on the amount of investment income a government may earn on proceeds from tax-exempt debt without having to rebate excess earnings to the federal government, known as arbitrage requirements (see paragraph 5.10).

5.07 Governments establish deposit and investment policies based on compliance requirements and other considerations (such as cash-flow needs), and often document those policies in writing and have them approved by the governing board.[1] Those policies often establish stated or implied investment objectives that include safety, liquidity, and yield. To help management adhere to those objectives, investment policies often list, among other things, the types and terms of investments that are permitted or prohibited. Some funds, such as pension trust and permanent funds, may have a higher risk tolerance, and thus may be authorized to invest in debt securities with a lower credit rating or a longer term to maturity than other funds, such as the general fund, where liquidity requirements require a lower risk tolerance. For some funds—again, such as pension trust and permanent funds—compliance requirements and investment policies may establish a "prudent person rule" rather than a "legal list" of permitted or prohibited investment types and terms.

5.08 Governments sometimes invest in sophisticated investments, including derivative instruments, which are discussed in "Part II—Accounting, Financial Reporting, and Auditing Considerations for Derivative Instruments"

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[1] GASB *Implementation Guide No. 2015-1* (GASB IG 2015-1) question 1.5.1 states that the diversity in practice prevents specifically defining what is meant by either a deposit or investment policy. However, for the purposes of GASB Statement No. 40, *Deposit and Investment Risks Disclosures—an amendment of GASB Statement No. 3*, as amended, an investment policy is considered to be a formally adopted policy that sets forth a government's allowable deposits or investments. An investment policy may be formally adopted through legal or contractual provisions or by other means, usually by the governing board. Governments should disclose deposit and investment and derivative instrument policies related to the risks that GASB Statement No. 40 and GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, require be disclosed. GASB Statement No. 40 does not require a government to establish deposit and investment policies, but does require it to disclose when it does not have a deposit or investment policy that addresses a specific type of risk to which it is exposed.

of this chapter. Other sophisticated investments include structured financial instruments, such as mortgage-backed securities. At times, the use of derivative instrument investments or other sophisticated investments may be inconsistent with a particular government's compliance requirements, investment policies, or investment objectives.

Collateralization of Deposits

5.09 Legal provisions often require financial institutions to collateralize governments' cash deposits when they exceed the amount of depository insurance. Those legal provisions usually specify the type and ratio or dollar amount of collateral that is required. That collateral protects governmental deposits against the financial failure of an institution. Individual financial institutions in some states, and groups of financial institutions in other states, are permitted to pledge collateral on a pooled basis to cover the combined accounts of all of their governmental depositors. See GASB Statement No. 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements*, as amended, and paragraph 4 of the GASB *Implementation Guide No. 2015-1* (GASB IG 2015-1) for questions and answers about common provisions and management issues relating to the pledging of collateral on deposits.

Arbitrage Requirements

5.10 *Arbitrage* is the excess profit earned from investing the proceeds of tax-exempt bonds in higher yielding taxable securities. Arbitrage requirements arising from the IRC and U.S. Treasury regulations generally require governments to rebate the excess investment earnings to the federal government. For this purpose, tax-exempt debt includes bonds and certain capital leases and installment purchases. Arbitrage requirements provide guidance with respect to various aspects of the calculation of an arbitrage rebate liability, including certain exceptions that may apply if debt proceeds are spent rapidly enough and for debt issuances under certain amounts. Excess earnings are required to be rebated every five years or upon maturity of the bonds, whichever is earlier. Governments generally should calculate the arbitrage liability annually to determine whether it is material and thus should be reported in the financial statements.

Deposit and Investment Risk

5.11 Like any entity, when a government places deposits with a financial institution or invests to earn a return, it exposes those amounts to risk: the probability or possibility of loss. Many of GASB's deposit and investment note disclosure standards are based on the objective of providing information about the risks of potential loss of resources. Three primary types of deposit and investment risks underlie those disclosure standards: credit, interest rate, and foreign currency risk:

- *Credit risk.* The risk that an issuer or other counterparty to an investment will not fulfill its obligations. In addition to the credit quality of the issuer of debt securities, credit risk includes concentration of credit risk and custodial credit risk, as follows:

- *Concentration of credit risk.* The risk of loss attributed to the magnitude of a government's investment in a single issuer.
- *Custodial credit risk.* For deposits, the risk that, in the event of the failure of a depository financial institution, a government will not be able to recover deposits or will not be able to recover collateral securities that are in the possession of an outside party. For investments, the risk that, in the event of the failure of the counterparty to a transaction, a government will not be able to recover the value of investment or collateral securities that are in the possession of an outside party.

- *Interest rate risk.* The risk that changes in interest rates will adversely affect the fair value of a debt investment.
- *Foreign currency risk.* The risk that changes in exchange rates will adversely affect the fair value of an investment or a deposit.

Internal Investment Pools

5.12 Governments commonly combine the cash and investments of several funds to enhance investment opportunities, operating efficiency, and physical custody and control. Those arrangements are known as *internal investment pools*. In some cases, internal pooling of cash and investments is prohibited by compliance requirements. For example, a bond indenture may prohibit combining the cash of a sinking fund with that of other funds. In other cases, the use of an internal investment pool may not be possible because different types of investments are authorized for different funds or because different funds have different investment objectives. For example, a pension trust fund may be allowed to enter into long-term investments, whereas the general fund may not be.

Reverse Repurchase Agreements

5.13 As part of their investment programs, some governments enter into reverse repurchase agreements and securities lending transactions. A reverse repurchase agreement is an agreement in which a government transfers securities to a broker-dealer or other entity for cash and simultaneously agrees to repay the cash plus interest in exchange for the same securities or for different securities (see paragraph 5.43).

Securities Lending Transactions

5.14 A securities lending transaction is an agreement in which a government transfers its securities to a broker-dealer or other entity for collateral—which may be cash, securities, or letters of credit—and simultaneously agrees to return the collateral for the same securities in the future. Depending on the nature of the collateral, the government may receive from or pay to the other party a fee for the securities lending transaction (see paragraph 5.44). If the collateral is cash, the lender typically earns a return by investing that cash at rates higher than the rate paid or rebated back to the borrower. If the collateral is something other than cash, the lender typically receives a fee.

Investment Arrangements, Including External Investment Pools

5.15 Governmental officials may conduct investment activity directly with brokers or financial services companies, or they may use investment advisers and managers to varying degrees. The approach used often is affected by the size and complexity of an entity's portfolio and the knowledge and experience of its investment personnel.

5.16 Governments often enter into cooperative investing agreements with other governments, or they place their moneys with the officials of other governments (such as state or county treasurers) for individual investing or for pooled investing with moneys from other governments. Governments also sometimes enter into agreements with nongovernmental investment managers for pooled investing with other of the managers' clients (for example, collateral pools on securities lending transactions). Those cooperative or pooled investment arrangements are known as *external investment pools*; those sponsored by individual state or local governments or jointly by more than one government are known as *governmental external investment pools*.

5.17 A government's relationships with investment counterparties usually are governed by written agreements that address appropriate matters, including, for example, the types and terms of investments that are permissible; the procedures for making investments; the procedures for the custody of the evidence of the investment; and the fees to be paid for the services provided. Also, agreements that govern external investment pools usually provide for the manner in which income, losses, and expenses will be shared and the circumstances under which each participant may redeem or liquidate its interest in the pool.

Accounting and Financial Reporting Considerations

General Recognition Standards

Investments

5.18 Paragraph 69 of GASB Statement No. 72, as amended, requires all investments be measured at fair value except as follows:

Exhibit 5-1: Investments Measured at Other than Fair Value

Investment	***Measurement***
Investments in nonparticipating interest-earning investment contracts	Cost-based measure (see paragraph 8 of GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*)
Investments in unallocated insurance contracts	Reported as interest-earning investment contracts (see paragraph 8 of GASB Statement No. 31 and paragraph 4 of GASB Statement No. 59, *Financial Instruments Omnibus*)
Money market investments and participating interest-earning investment contracts with remaining maturity at time of purchase of one year or less and are held by governments other than external investment pools	Amortized cost (permitted but not required per paragraph 9 of GASB Statement No. 31, otherwise fair value)
Investments *held by* qualified external investment pools	Amortized cost (see paragraph 4 of GASB Statement No. 79, *Certain External Investment Pools and Pool Participants*)
Investments *in* qualified external investment pools	Amortized cost (see paragraph 41 of GASB Statement No. 79 if the pool meets the criteria to measure its investments at amortized cost)
Synthetic guaranteed investment contracts (SGICs) that are fully benefit responsive	Contract value (see paragraph 67 of GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*)
Investments in life insurance contracts	Cash surrender value (see paragraph 69g of GASB Statement No. 72)

Emphasis Point

GASB Statement No. 72 provides comprehensive guidance for all circumstances in which investments should be measured (reported) at fair value. Additionally, there are several GASB standards that were issued prior to GASB Statement No. 72 that require the reporting of certain investments at fair value. GASB Statement No. 72 did not supersede the relevant paragraphs from those standards because they are not in conflict with GASB Statement No. 72.

The following GASB standards are those that contain requirements for reporting certain investments at fair value but were not superseded by GASB Statement No. 72:

- GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*
- GASB Statement No. 32, *Accounting and Financial Reporting for Internal Revenue Code Section 457 Deferred Compensation Plans—a rescission of GASB Statement No. 2 and an amendment of GASB Statement No. 31*
- GASB Statement No. 52, *Land and Other Real Estate Held as Investments by Endowments*
- GASB Statement No. 67, *Financial Reporting for Pension Plans—an amendment of GASB Statement No. 25*

5.19 GASB IG 2015-1 question 1.43.4 requires governments to follow trade date accounting. The trade date is the date an investment order is made. Therefore, investment transactions should not be accounted for based on the settlement date, which is the date on which the investment securities are delivered or received in exchange for the cash payment.

5.20 Fair value measurements should be made consistent with the provisions of paragraphs 5–63 of GASB Statement No. 72, except as discussed in the following paragraphs related to investments in certain entities that calculate net asset value (NAV) per share. See further discussion of fair value measurement principles in chapter 2.

Investments in Certain Entities That Calculate the NAV per Share (or Its Equivalent)

5.21 If an investment in a nongovernmental entity does not have a readily determinable fair value, a government is permitted to establish the fair value by using the NAV per share (or its equivalent), as discussed in paragraph 71 of GASB Statement No. 72. Examples of NAV per share include member units or an ownership interest in partners' capital to which a proportionate share of net assets is attributed. This method of determining fair value is permitted if the NAV per share (or its equivalent) of the investment is calculated as of the government's measurement date generally in a manner consistent with FASB's measurement principles for investment companies. A government should determine that the NAV per share (or its equivalent) provided by the investee is determined in that manner.

Emphasis Point

Investments should not be valued using NAV per share (as a practical expedient for fair value) if they have a readily determinable fair value or if the investment is in a governmental entity (for example, a government investment pool). As stated in paragraph 86 of GASB Statement No. 72, an equity security has a readily determinable fair value if it meets any of the following conditions:

a. The fair value of an equity security is readily determinable if sales prices or bid-and-asked quotations are currently available on a securities exchange registered with the U.S. Securities and

Exchange Commission or in the over-the-counter market, provided that those prices or quotations for the over-the-counter market are publicly reported by the National Association of Securities Dealers Automated Quotations systems or by OTC Markets Group, Inc. Restricted stock meets that definition if the restriction terminates within one year.

b. The fair value of an equity security traded only in a foreign market is readily determinable if that foreign market is of a breadth and scope comparable to one of the U.S. markets referred to in item *a*.

c. The fair value of an investment in a mutual fund is readily determinable if the fair value per share (unit) is determined and published and is the basis for current transactions.

5.22 As discussed in paragraph 72 of GASB Statement No. 72, if the NAV per share (or its equivalent) of an investment obtained from the investee is not determined as of a government's measurement date or is not calculated in a manner consistent with the measurement principles for investment companies, the government should consider whether an adjustment to the most recent NAV per share (or its equivalent) is necessary. The objective of any adjustment is to determine the NAV per share (or its equivalent) for the investment that is calculated as of the government's measurement date in a manner consistent with the measurement principles for investment companies.

Emphasis Point

In accordance with paragraph 73 of GASB Statement No. 72, the ability to establish fair value using NAV as a practical expedient should be determined on an investment-by-investment basis. The method of determining fair value should be applied consistently to the fair value measurement of the government's entire position in a particular investment, unless it is probable at the measurement date that the government will sell a portion of an investment at an amount different from the NAV per share (or its equivalent).

5.23 In accordance with paragraph 74 of GASB Statement No. 72, the method of determining fair value discussed in paragraph 5.21 should *not* be applied if, as of the government's measurement date, it is probable that the government will sell the investment for an amount different from the NAV per share (or its equivalent). A sale is considered probable only if all of the following criteria have been met, as of the government's measurement date:

- The government, having the authority to approve the action, commits to a plan to sell the investment.
- An active program to locate a buyer and other actions required to complete the plan to sell the investment have been initiated.
- The investment is available for immediate sale subject only to terms that are usual and customary for sales of such investments (for example, a requirement to obtain approval of the sale from the investee, or a buyer's due diligence procedures).
- Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

Equity Interests in Common Stock That Does Not Meet the Definition of an Investment

5.24 Equity interests in common stock that meet certain criteria as discussed in paragraph 5.25 should be accounted for using the equity method, not the fair value method. However, paragraph 77 of GASB Statement No. 72 excludes the following investments from using the equity method of accounting:

a. Common stock held by

  i. external investment pools;

  ii. pension or postemployment benefit plans other than pension (OPEB) plans;

  iii. IRC Section 457 deferred compensation plans; or

  iv. endowments (including permanent and term endowments) or permanent funds.

b. Investments in certain entities that calculate the NAV per share (or its equivalent) as discussed in paragraphs 5.21–5.23

c. Equity interest ownership in joint ventures or component units as provided in GASB Statement No. 14, *The Financial Reporting Entity*, as amended.

5.25 The criteria for applying the equity method are addressed in paragraphs 205–208 of GASB Statement No. 62. The equity method of accounting for an investment in common stock should be followed by a government whose investment in voting stock gives it the ability to exercise significant influence over operating and financial policies of an investee, even though the government holds 50 percent or less of the voting stock. Ability to exercise that influence may be indicated in several ways, such as representation on the governing body, participation in policy-making processes, significant intra-entity transactions, interchange of managerial personnel, or technological dependency. Another important consideration is the extent of ownership by a government in relation to the concentration of other shareholdings, but substantial or majority ownership of the voting stock of an investee by another investor does not necessarily preclude the ability to exercise significant influence by the government. Determining the ability of a government to exercise such influence is not always clear, and applying judgment is necessary to assess the status of each investment. An investment (direct or indirect) of 20 percent or more of the voting stock of an investee should lead to a presumption that in the absence of evidence to the contrary, a government has the ability to exercise significant influence over an investee. Conversely, an investment of less than 20 percent of the voting stock of an investee should lead to a presumption that a government does not have the ability to exercise significant influence unless that ability can be demonstrated.

5.26 In accordance with paragraph 203 of GASB Statement No. 62 under the equity method, an investor initially records an investment in the stock of an investee at cost under the equity method and adjusts the carrying amount of the investment to recognize the investor's share of the earnings or losses of the investee after the date of acquisition. The amount of the adjustment is included in the determination of the changes in net assets by the investor. Such amount reflects adjustments, including adjustments to eliminate inter-entity gains and losses, and to amortize, if appropriate, any difference between investor cost and underlying equity in net assets of the investee at the date of investment. The investment of an investor is also adjusted to reflect the investor's share of changes in the investee's capital. Dividends received from an investee reduce the carrying amount of the investment. A series of operating losses of an investee or other factors may indicate that a decrease in value of the investment has occurred that is other than temporary and that should be recognized even though the decrease in value is in excess of what would otherwise be recognized by application of the equity method.

Financial Statement Presentation

Financial Position Classifications

5.27 Each of a government's funds, activities, and component units should report its own deposits and investments, including its equity position in internal investment pools. GASB IG 2015-1 question 6.29.3 states that each fund with a position in the internal investment pool should report it as, for example, "equity in cash management pool," "equity in internal investment pool," "cash and cash equivalents," or "investments." It also sometimes is necessary to classify certain deposits and investments as restricted assets because their use is limited by legal or contractual arrangements, such as debt covenants. (See the discussion of restricted assets in chapter 2.)

> **Update 5-1 *Fiduciary Activities***
>
> GASB Statement No. 84, *Fiduciary Activities*, establishes criteria for identifying and reporting fiduciary activities. The criteria for identification of fiduciary activities primarily focuses on (a) whether a government controls the assets of the fiduciary activity and (b) the beneficiaries with whom a fiduciary relationship exists.
>
> Governments with activities meeting the criteria will present a statement of fiduciary net position and a statement of changes in fiduciary net position, with certain exceptions.
>
> There are four classifications of fiduciary funds described in GASB Statement No. 84: (1) pension (and other employee benefit) trust funds, (2) investment trust funds, (3) private-purpose trust funds, and (4) custodial funds. Custodial funds should report fiduciary activities that are not held in a trust or equivalent arrangement that meets specific criteria. Note that agency funds will no longer be reported upon application of this statement.
>
> The statement was issued in January 2017 and is effective for fiscal years beginning after December 15, 2018. Earlier application is encouraged.
>
> The full text of the statement is available on GASB's website at www.gasb.org.
>
> Upon its effective date, GASB Statement No. 84 will affect the category B guidance in this chapter.
>
> The full text of the statement is available on GASB's website at www.gasb.org.

5.28 When one fund has overdrawn its share of an internal investment pool, that fund should report an interfund liability to the fund that the government's management deems to have lent the amount to the overdrawn fund.[2]

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[2] Such overdrawn positions may represent instances of noncompliance if the government has a prohibition against interfund borrowing.

The fund deemed to have lent the amount should report an interfund receivable from the borrowing fund. This treatment is unaffected by whether the lending and borrowing funds are of the same or different fund types or categories. However, in the government-wide financial statements, those interfund accounts should be eliminated as required for internal balances by GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, paragraph 58. (See the discussion of interfund eliminations in chapter 9, "Interfund, Internal, and Intra-Entity Activity and Balances.") If a cash account for the government is overdrawn in total, the balance should be classified as a liability in the fund and government-wide financial statements.

5.29 Some governments consider their arbitrage rebate liability to be a liability generated from an inflow of resources and adjust interest earnings for the annual change in the liability. Other governments consider the arbitrage rebate liability to be generated from an outflow of resources and adjust expenses for the annual change in the liability. With the outflow of resources-generated approach, expenditure recognition and liability reporting in the governmental funds is subject to the modified accrual basis of accounting.

5.30 Agency funds may have negative cash balances because more cash has been paid out than received. The funds also may have incurred more liabilities than there are assets to pay them. In those cases, the government may have a liability to cover the shortages with amounts from other funds and should report an interfund receivable in the agency funds.

Activity Statement Classifications

5.31 Paragraph 13 of GASB Statement No. 31 provides that when the change in the fair value of investments is identified separately as an element of investment income, it should be captioned "net increase (decrease) in the fair value of investments." For investments reported at fair value, realized gains and losses should not be displayed separately from the net increase (decrease) in the fair value of investments within the investment revenue classification on the flow of resources statement (statement of activities; statement of revenues, expenditures, and changes in fund balance; and statement of revenues, expenses, and changes in fund net position). However, an entity may disclose realized gains and losses in the notes to the financial statements. (Different display standards apply for defined benefit pension plans and OPEB plans, as discussed later in this chapter.)

5.32 GASB IG 2015-1 question 6.14.1 indicates that realized gains and losses and the amortization of premiums and discounts may be reported for certain investments that are reported using cost-based measures. If that is done, that IG 2015-1 question states that the financial statements should clearly indicate that the presentation applies only to securities reported at amortized cost.

5.33 Paragraph 14 of GASB Statement No. 31, as amended, states that, often, income from investments associated with one fund is assigned to another fund because of legal or contractual provisions. In that situation, the accounting treatment should be based on the specific language of the legal or contractual provisions. If, however, the investment income is assigned to another fund for other than legal or contractual reasons (for example, management decision), the income should be recognized in the fund that reports the investments. The transfer of that income to the recipient fund should be reported as an interfund transfer.

5.34 Paragraph 51 of GASB Statement No. 34 provides that earnings on endowments or permanent fund investments should be reported as program revenues within the investment revenue classification on the flow of resources statement (that is, statement of activities) if the earnings are restricted to one or more programs specifically identified in the endowment or permanent fund agreement or contract. It also states that investment earnings should be reported as program revenues when legal restrictions require the earnings from the investment of accumulated program resources to be used for that program. If investment earnings do not meet either of those criteria, they should be reported as general revenues. Question 7.37.3 of GASB IG 2015-1 discusses how the change in fair value of investments is classified as program or general revenues.

5.35 In proprietary funds, interest income generally is reported as nonoperating revenue on the flow of resources statement (that is, statement of revenues, expenses, and changes in fund net position). However, it should be classified as operating revenue when it meets the definition of operating revenue that is appropriate to the nature of the activity. For example, footnote 42 to GASB Statement No. 34 states that interest revenue should be reported as operating revenue by a proprietary fund established to provide loans to first-time homeowners. See the further discussion of the classification of operating revenue in chapter 6, "Revenues and Receivables."

Fund Classification—Individual Investment Accounts

5.36 Some governments provide individual investment accounts to other, legally separate entities that are not part of the same financial reporting entity by acquiring specific investments for those other entities. With individual investment accounts, the investments' income and value changes affect only the entity for which the investments were acquired. Paragraph 20 of GASB Statement No. 31 states that governments that provide individual investment accounts should report those investments in one or more separate investment trust funds. The financial reporting for investment trust funds is described in a section of chapter 12, "Special-Purpose and State Governments," on governmental external investment pools.

Additional Considerations for Defined Benefit Pension Plans

5.37 Chapter 13, "Defined Benefit Pension Plans (Plan & Employer Considerations)," discusses the accounting and financial reporting standards for defined benefit pension plans and defined contribution pension plans that are administered through trusts or equivalent arrangements that meet the specified criteria. In summary, paragraph 18 of GASB Statement No. 67, as amended, requires investments, unless otherwise specified, to be reported at fair value. The guidance in GASB Statement No. 72 on measuring fair value also applies to the investments of defined benefit pension plans. Unallocated insurance contracts should be reported as interest-earning investment contracts in accordance with paragraphs 7–11 of GASB Statement No. 31, as amended. In accordance with paragraph 19 of GASB Statement No. 67, allocated insurance contracts should be excluded from plan assets.

5.38 Presentation requirements for investment income and expense reported in the statement of changes in fiduciary net position are discussed in paragraphs 23–26 of GASB Statement No. 67 and chapter 13 of this guide.

Additional Considerations for Defined Benefit OPEB Plans

5.39 The investment accounting and financial reporting standards established in GASB Statement No. 74, *Financial Reporting for Postemployment Benefit Plans Other than Pension Plans*, for OPEB plans that are administered through trusts or equivalent arrangements that meet the specified criteria are similar to those established in GASB Statement No. 67, as amended. GASB Statement No. 74 paragraph 28 requires the additions section of the statement of changes in fiduciary net position to include a separate category that displays net investment income, including (a) the net increase (decrease) in the fair value of OPEB plan investments; (b) interest income, dividend income, and other income not included in item a; and (c) investment expense, separately displayed, including investment management and custodial fees and all other significant investment-related costs. Paragraph 34 of GASB Statement No. 74 requires certain disclosures about plan investments in addition to those required by other GASB standards and discussed in paragraph 5.50. Chapter 14, "Defined Benefit Postemployment Benefits Other Than Pensions (Plan & Employer Considerations)," discusses the accounting and financial reporting standards for OPEB and OPEB plans.

Additional Considerations for Investments Held by Governmental External Investment Pools

5.40 The principal GASB pronouncement relating to the accounting and financial reporting for governmental external investment pools is GASB Statement No. 31, as amended. Paragraph 11 of the GASB IG 2015-1 provides additional guidance.

5.41 The manner in which governmental external investment pools value their investments depends on whether the pool meets the criteria of GASB Statement No. 79, *Certain External Investment Pools and Pool Participants*. Governmental external investment pools, other than qualifying external investment pools, generally report investments at fair value. A qualifying external investment pool may elect to measure all of its investments at amortized cost if it meets all of the following criteria: (*a*) the pool transacts with its participants at a stable net asset value per share and (*b*) the portfolio meets certain maturity, quality, diversification, liquidity, and shadow pricing requirements.

Emphasis Point

As discussed in the Emphasis Point following paragraph 5.21, investments should not be valued using NAV per share (as a practical expedient for fair value) if they have a readily determinable fair value or if the investment is in a governmental entity (for example, a government investment pool).

5.42 Chapter 12 discusses the accounting and financial reporting standards for governmental external investment pools, including the standards relating to investments. That chapter also discusses the accounting and financial reporting standards when those pools are included in the financial statements of the sponsoring government.

Additional Considerations for Reverse Repurchase Agreements

5.43 GASB Statement No. 3, as amended, includes accounting and financial reporting standards for reverse repurchase agreements. Yield maintenance reverse repurchase agreements, which are defined in GASB Statement No. 3, as amended, are accounted for as sales and purchases of securities. The assets and liabilities arising from other reverse repurchase agreements are not netted on the financial position statements. Rather, they are separately reported as "investments" and "obligations under reverse repurchase agreements." Similarly, the interest cost of those other agreements is reported as interest expense or expenditure and not netted with interest earned on any related investments. GASB Statement No. 3, as amended, also addresses the accounting for reverse repurchase agreements when investing on a pooled basis. It also requires various specific disclosures about the agreements, which are presented in nonauthoritative illustrations in Appendix B1-2 of the GASB IG 2015-1.

Additional Considerations for Securities Lending Transactions

5.44 The accounting and financial reporting standards for securities lending transactions are in GASB Statement No. 28, *Accounting and Financial Reporting for Securities Lending Transactions*, as amended. Governmental entities should report the securities lent as assets. Cash received as collateral on securities lending transactions and investments made with that cash should be reported as assets, and the obligation to return that cash should be reported as a liability. Securities received as collateral also should be reported as assets if the governmental entity has the ability to pledge or sell them without a borrower default. Liabilities resulting from these transactions should be reported in the statement of net position. Securities lending transactions collateralized by letters of credit or by securities that the governmental entity does not have the ability to pledge or sell unless the borrower defaults should not be reported as assets and liabilities.

5.45 The costs of securities lending transactions, such as borrower rebates (interest costs) and agent fees, should be reported as expenditures or expenses. These costs should not be netted with interest revenue or income from the investment of cash collateral, any other related investments, or loan premiums or fees.

5.46 GASB Statement No. 28, as amended, also addresses the accounting for securities lending transactions when investing on a pooled basis and requires various specific disclosures about the transactions, which are presented in a nonauthoritative illustration 12 in Appendix B1-2 of the GASB IG 2015-1. GASB IG 2015-1 question 6.12.9 clarifies that the provisions of GASB Statement No. 31, as amended, apply to the measurement of invested collateral, such as investments in collateral investment pools and corporate debt securities purchased with cash collateral.

Note Disclosures—Investments

5.47 In accordance with paragraphs 11 and 63 of GASB Statement No. 14, as amended, investment disclosures should distinguish between the primary government and its discretely presented component units. The reporting government's financial statements should make those discretely presented component unit disclosures that are essential to fair presentation of the basic financial statements. Except for required disclosures about certain pensions administered through trusts or equivalent arrangements that meet the specified criteria, determining which component unit disclosures are essential to fair presentation is a matter of professional judgment and should be done on a component unit-by-component-unit basis.

Legal and Contractual Provisions

5.48 In accordance with paragraph 65 of GASB Statement No. 3, as amended, governments should disclose the types of investments authorized by legal or contractual provisions. If the types of investments authorized for different funds, fund types, blended component units, or discretely presented component units differ significantly from those authorized for the primary government, and those funds, fund types, or component units have material investment activity compared with the reporting entity's investment activity, the differences in authorized investment types should be disclosed.

5.49 In accordance with paragraph 66 of GASB Statement No. 3 and paragraph 9 of GASB Statement No. 38, *Certain Financial Statement Note Disclosures*, governments should disclose significant violations during the period of legal or contractual provisions for deposits and investments (including provisions other than those disclosed in accordance with paragraph 65 of GASB Statement No. 3, as amended) and the actions taken to address such violations should also be disclosed. For example, if state statutes require collateral on deposits to be held by the entity's independent third-party agent but the collateral was usually held by the pledging financial institution's trust department, that should be disclosed.

Valuation and Related Disclosures

Emphasis Point

In accordance with paragraph 80 of GASB Statement No. 72, valuation and related disclosures required by GASB Statement No. 72 should be organized by type of asset or liability. The following should be taken into consideration when determining the level of detail and disaggregation and how much emphasis to place on each disclosure requirement:

- The nature, characteristics, and risks of an asset or a liability
- The level of the fair value hierarchy within which the fair value measurement is categorized
- Whether a GASB standard specifies a type for an asset or a liability
- The objective or the mission of the government
- The characteristics of the government
- Relative significance of assets and liabilities
- Whether separately issued financial statements are available
- Line items presented in the statement of net position

Chapter 2 of this guide discusses measurement principles including valuation techniques, inputs to valuation, and the fair value hierarchy.

5.50 Paragraph 81 of GASB Statement No. 72 addresses note disclosure requirements related to investments measured at fair value. The following are among the required disclosures:

- For recurring and nonrecurring fair value measurements:
  - — Fair value measurement at end of reporting period
  - — Fair value hierarchy level (except for investments that are measured at the NAV per share)

  - — Description of valuation techniques used
  - — Change in valuation technique, if applicable, that has a significant impact on measurement, including the reason for making the change

- For nonrecurring fair value measurements, the reason for the measurement

Emphasis Point

As discussed in the Emphasis Point after paragraph 5.22, in accordance with paragraph 73 of GASB Statement No. 72, the ability to establish fair value using NAV as a practical expedient should be determined on an investment-by-investment basis. The method of determining fair value should be applied consistently to the fair value measurement of the government's entire position in a particular investment, unless it is probable at the measurement date that the government will sell a portion of an investment at an amount different from the NAV per share (or its equivalent).

5.51 Paragraph 82 of GASB Statement No. 72 addresses additional note disclosure requirements related to investments that meet the criteria for reporting at NAV per share (or its equivalent) as a practical expedient for fair value. The following are among the required disclosures for *each type* of investment as of the end of the reporting period:

- Fair value measurement at the measurement date
- Description of significant investment strategies
- For each type of investment that includes investments that can never be redeemed with the investees, but a government receives distributions through the liquidation of the underlying assets of the investees, the government's estimate of the period over which the underlying assets are expected to be liquidated by the investees
- Amount of unfunded commitments
- Description of terms and conditions of redemption
- Circumstances in which an otherwise redeemable investment in the type (or a portion thereof) might not be redeemable
- For those otherwise redeemable investments that are restricted from redemption as of the government's measurement date, the estimate of when the restriction from redemption might lapse; if an estimate cannot be made, disclose that fact and how long the restriction has been in effect
- Any other significant restriction on the ability to sell investments in the type at the measurement date
- If a government determines that it is probable that it will sell an investment(s) for an amount different from the NAV per share (or its equivalent), the total fair value of all investments that meet the criteria in paragraph 74 of GASB Statement No. 72 and any remaining actions required to complete the sale

- If a group of investments would otherwise meet the criteria in paragraph 74 of GASB Statement No. 72 but the individual investments to be sold have not been identified, such that the investments continue to qualify for the method of determining fair value in paragraph 71 of GASB Statement No. 72, the government's plans to sell and any remaining actions required to complete the sale

5.52 Paragraph 15 of GASB Statement No. 31, as amended, addresses other note disclosure requirements related to valuation and reporting of investments. The following are among the required disclosures:

- Policy for determining which investments, if any, are reported at amortized cost
- For any investments in external investment pools that are not SEC-registered, a brief description of any regulatory oversight for the pool and whether the fair value of the position in the pool is the same as the value of the pool shares
- Any involuntary participation in an external investment pool
- If an entity cannot obtain information from a pool sponsor to allow it to determine the fair value of its investment in the pool, the methods used and significant assumptions made in determining that fair value and the reasons for having had to make such an estimate
- Any income from investments associated with one fund that is assigned to another fund

Deposit and Investment Risk Disclosures

Emphasis Point

In accordance with GASB Statement No. 40, *Deposit and Investment Risk Disclosures—an amendment of GASB Statement No. 3*, deposit and investment risk disclosures generally should be made for the primary government, including its blended component units. Risk disclosures should also be made for governmental and business-type activities, individual major funds, nonmajor funds in the aggregate, or fiduciary fund types when the risk exposures are significantly greater than the deposit and investment risks of the primary government. For example, a primary government's total investments may not be exposed to concentration risk. However, if the government's capital projects fund (major fund) has all of its investments in one issuer of corporate bonds, disclosure should be made for the capital projects fund's exposure to a concentration of credit risk.

Additionally, unless otherwise required, investment risk disclosures should be organized by investment type, such as U.S. Treasuries, corporate bonds, or commercial paper. Dissimilar investments, such as U.S. Treasury bills and U.S. Treasury strips, should not be aggregated into a single investment type.

5.53 GASB Statement No. 40 addresses note disclosure requirements related to deposit and investment risks, including credit risk, interest rate risk, and foreign currency risk. The following are among the required disclosures as of the end of the reporting period:

- Credit quality ratings of investments in debt securities

Emphasis Point

The disclosure for credit quality ratings does not apply to investments issued or explicitly guaranteed by the U.S. government, but does apply to investments in external investment pools, money market funds, bond mutual funds, and other pooled investments of fixed-income securities. If a credit quality disclosure is required and the investment is unrated, the disclosure should indicate that fact.

- For deposits at the end of the period that are exposed to custodial credit risk, the amount of those bank balances, the fact that the balances are uninsured, and the basis on which the balances are exposed to custodial credit risk
- For investment securities, including securities underlying repurchase agreements, at the end of the period that are exposed to custodial credit risk, the investment type, the reported amount, and how the investments are held (does not apply to investments in external investment pools and in open-end mutual funds or to securities underlying reverse repurchase agreements)

Emphasis Point

The disclosure of custodial credit risk for deposits and investment securities is perhaps the most unique of the government-specific disclosures for deposits and investments. Paragraphs 8–10 of GASB Statement No. 40 provide standards for the custodial credit risk disclosure, and paragraph 4 of the GASB IG 2015-1 provides guidance. Deposits are exposed to custodial credit risk if they are not covered by depository insurance and the deposits are (*a*) uncollateralized, (*b*) collateralized with securities held by the pledging financial institution, or (*c*) collateralized with securities held by the pledging financial institution's trust department or agent but not in the depositor-government's name. Investment securities are exposed to custodial credit risk if the securities are uninsured, are not registered in the name of the government, and are held by either (*a*) the counterparty or (*b*) the counterparty's trust department or agent but not in the government's name.

- Investments in any one issuer, by amount and issuer, that represent 5 percent or more of total investments (does not apply to investments issued or explicitly guaranteed by the U.S. government or investments in mutual funds, external investment pools, or other pooled investments)
- Information about interest rate risk using one of five methods

Emphasis Point

Paragraph 15 of GASB Statement No. 40, as amended, requires that governments disclose information about interest rate risk using one of the following five methods, which range from the simple to the complex: (*a*) segmented time distribution, (*b*) specific identification, (*c*) weighted average maturity, (*d*) duration, and (*e*) simulation model. The nonauthoritative glossary in paragraph 19 of GASB Statement No. 40 defines each of those methods. GASB Statement No. 40 encourages governments to select the disclosure method that is most consistent with the method they use to identify and manage interest rate risk. GASB IG 2015-1 questions 1.57.2 and 1.57.4 indicate that a government may choose to use different methods to disclose interest rate risk among its various investment portfolios or funds in the same year. However, question 1.57.2 also states that if a government chooses to use different methods from year to year, it should disclose that as a change in accounting principle in accordance with paragraph 75 of GASB Statement No. 62.

- If a method requires an assumption regarding timing of cash flows, interest rate changes, or other factors that affect interest rate risk information, that assumption should be disclosed
- The terms of debt investments that cause their fair values to be highly sensitive to changes in interest rates
- The U.S. dollar balances of deposits or investments exposed to foreign currency risk, organized by currency denomination and, if applicable, investment type

Note Disclosures—Securities Lending Transactions

5.54 GASB Statement No. 28, as amended, addresses note disclosures for securities lending transactions. The following are among the required disclosures as of the end of the reporting period:

- Authority for securities lending and any violations
- Description of the securities lending transactions, including types of securities lent, types of collateral received, and whether the government has the ability to pledge or sell collateral securities
- Amount by which the value of collateral provided is required to exceed the value of securities lent
- Whether the maturities of investments made with invested collateral generally are matched to the maturities of the securities loans
- Amount of credit risk assumed
- Amounts of losses arriving from securities lending transactions

Note Disclosures—Certain Equity Interests in Common Stock

5.55 Paragraph 210 of GASB Statement No. 62 addresses note disclosures for equity interests in common stock that do not meet the definition of an investment but that otherwise meets the criteria for recognizing an equity interest. The following are among the required disclosures:

- Name of each investee and percentage of ownership of common stock
- Accounting policies of the government with respect to investments in common stock
- Difference, if any, between amount at which investment is carried and amount of underlying equity in net assets and the accounting treatment of the difference
- For those investments in common stock for which a quoted market price is available, the aggregate value of each identified investment based on the quoted market price should be disclosed

- Summarized information about assets, liabilities, and results of operations of the investees (if significant in relation to the financial position or results of operations of a government)
- Significant effects, if applicable, of possible conversions, exercise of options and warrants, or contingent issuances

Auditing Considerations for Investments and Certain Equity Investments

5.56 This section discusses audit considerations, including describing the relevant assertions when auditing investments and certain equity interests. This section does not include all risks or all procedures that could apply to such audits in accordance with GAAS; instead, this section focuses on specific considerations for testing investments and certain equity interests. The examples of substantive audit procedures are not considered required procedures, nor are they all-inclusive.

Emphasis Point

Governments may invest in a variety of investments—exchange-traded equity securities, fixed income securities (for example, corporate bonds or asset-backed securities), mutual funds, government investment pools, and alternative investments (for example, private equity funds, or hedge funds). Though procedures for auditing investments address each relevant assertion, the valuation assertion often involves greater auditing considerations due to the complexity of measuring investments. The audit approach will vary significantly depending upon the fair value measurements used and the associated risk of material misstatement. The valuation method used for the measurement or disclosure (for example, cost, equity method, or fair value) is a significant factor in properly designing tests of valuation.

Understanding the different investments the government holds and the inputs and methods the government uses to value investments will determine what portions of the "Auditing Considerations for Investments and Certain Equity Interests" section of the chapter are most applicable to the audit.

Risk Assessment

5.57 The auditor should perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the relevant assertion levels for investments and certain equity investments in accordance with AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*). It provides a basis for considering the appropriate audit approach for designing and performing further audit procedures in accordance with AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), including both substantive procedures and tests of controls.

Overall Considerations Relating to Investments and Certain Equity Interests

5.58 Paragraph .02 of AU-C section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* (AICPA, *Professional Standards*), explains that the degree of estimation uncertainty affects the risk of material misstatement of accounting estimates. Factors affecting the risk of material misstatement include the

- complexity of investments;
- level of uncertainty and variability of future cash flows;
- volume of investments to which the entity is exposed;
- terms of the investment, including whether the investment itself includes other financial instruments; and
- nature of the investments.

5.59 The auditor's assessment of the risk of material misstatement at the assertion level for investments and certain equity interests may change during the course of the audit as additional information is obtained. Throughout the audit, additional information may become available that results in updates being made to certain risk assessment decisions, including identification of significant risks related to estimates.

Identification of Material Classes of Transactions, Account Balances, and Disclosures

5.60 When identifying material classes of transactions, account balances, and disclosures and their relevant assertions, the auditor often starts by considering financial statement line items as accounts. However, if the financial statement line items contain general ledger accounts (or groups of general ledger accounts) with different risks, the auditor may disaggregate them further to the level of general ledger accounts or a group of such accounts, based on his or her assessment of the risk of material misstatement.

5.61 The auditor may disaggregate an entity's investment portfolio into groups based on common risk profiles by considering a combination of the following factors (in addition to other factors which may be applicable):

- Type of investment (for example, exchange-traded securities, investment grade corporate debt, high yield or non-investment grade corporate debt, or structured debt securities)
- Management's method of estimating fair value (for example, third-party pricing source, broker quote, external valuation firm, or internal model)
- Recent levels of market activity

5.62 Risk should be considered both qualitatively and quantitatively when identifying material classes of transactions, account balances, and disclosures. The determination whether there are multiple material classes of transactions, account balances, and disclosures is dependent upon whether they are subject to differing risks. The disaggregation of an investment portfolio based on varying levels of risk affects the auditor's assessment of the risk of material misstatement because different types of investments within the portfolio may have differing levels of risk. The considerations for determining significant risks at material classes of transactions, account balances, and disclosures due to fraud or error include availability of reliable market information, the level of subjectivity involved in the valuation, and other factors in paragraph 5.58. In addition, the individual investments within the portfolio may have different valuation process controls in place that will affect the overall control risk assessment.

Emphasis Point

An auditor (valuation) specialist may be useful in the decisions related to disaggregation of material classes of transactions, account balances, and disclosures or to provide insight into the risk level of the disaggregated investments, including

- assisting with obtaining an understanding of the portfolio through meetings with management, portfolio managers, traders, and the like; identifying and documenting key risks; and
- reviewing the entity's investment portfolio to assist in disaggregating the population into appropriate classes of investments based on risks, and documenting conclusions.

5.63 The following table provides a simplified example of disaggregating the classes of types of investments within an investment portfolio based on valuation risk. Auditors are cautioned from disaggregating the investment portfolio solely by common name (for example, non-investment grade corporate debt) and rather, consider the individual characteristics of investments when disaggregating the portfolio.

Exhibit 5-2: Example Disaggregation of an Investment Portfolio Based on Valuation Risk

Lower Valuation Risk	***Higher Valuation Risk***[1]
Readily Determinable Fair Values based on Market Quotations or NAV • Exchanged traded equities • Over the Counter (OTC) forward contracts—currencies • Registered investment companies • Non-registered mutual funds • Exchanged-traded derivatives *Matrix / Other Models with Observable Inputs* • Investment-grade corporate debt • Higher credit quality municipal debt securities • Convertible corporate debt • Interest rate swap derivatives • U.S. agency securities	• Non-investment grade corporate debt • Non-agency residential mortgage-backed securities (RMBS)/ collateralized mortgage obligations (CMOs) • Collateralized debt obligations (CDOs) • Non-exchanged traded securities • Investment LPs/LLCs • Credit default swap derivatives • Commercial mortgage-backed securities (CMBS) • Bank loans • Direct private equity investments • Real estate investment trusts (REITs)

[1] Less active markets are more likely to be priced using significant unobservable inputs.

Identification of Significant Risks Related to Valuation

5.64 The auditor's risk assessment process may lead the auditor to identify one or more significant risks relating to the valuation of investments and certain equity interests. Consideration in the risk assessment process may include:

- High measurement uncertainty related to the valuation of investments (for example, those with unobservable inputs)
- Nature of evidence to support management's valuation of its investments
- Degree of management understanding of its investments or expertise necessary to value such instruments properly, including the ability to determine whether valuation adjustments are needed
- Degree of management understanding of complex requirements of generally accepted accounting principles (GAAP) relating to measurement and disclosure of investments and the inability of management to make the judgments required to properly apply those requirements
- The significance of valuation adjustments made to valuation technique outputs when GAAP require or permit such adjustments.

5.65 Paragraph .15 of AU-C section 540 states, for accounting estimates that give rise to significant risks, in addition to other substantive procedures performed to meet the requirements of AU-C section 330, the auditor should evaluate the following:

a. How management has considered alternative assumptions or outcomes and why it has rejected them or how management has otherwise addressed measurement uncertainty in making the accounting estimate

b. Whether the significant assumptions used by management are reasonable

c. When relevant to the reasonableness of the significant assumptions used by management or the appropriate application of GAAP, management's intent to carry out specific courses of action and its ability to do so

5.66 As markets become inactive, the change in circumstances may lead to a move from valuation by market price to valuation by model or may result in a change from one particular model to another. Reacting to changes in market conditions may be difficult if management does not have policies in place prior to their occurrence. Management also may not possess the expertise necessary to develop a model on an urgent basis or select the valuation technique that may be appropriate in the circumstances. Even when valuation techniques have been consistently used, a need exists for management to examine the continuing appropriateness of the valuation techniques and assumptions used for determining valuation of investments. Further, valuation techniques may have been selected in times when reasonable market information was available, but that information may not provide reasonable valuations in times of unanticipated stress.

5.67 The susceptibility to management bias, whether intentional or unintentional, increases with the subjectivity of the valuation and the degree of measurement uncertainty. For example, management may choose to ignore observable marketplace assumptions or data and instead use its own internally-developed assumptions if those assumptions yield more favorable results. Even without fraudulent intent, there may be a natural temptation to bias judgments toward the most favorable end of what may be a wide spectrum rather than the point in the spectrum that might be considered to be most consistent with GAAP. For example, an investment portfolio where management's pattern of selecting point estimates consistently tends toward a higher or lower portion of the acceptable range may be an indication of intentional bias. Changing the valuation technique from period to period without a clear and appropriate reason for doing so may also be an indicator of management bias. Although some form of management bias is inherent in subjective decisions relating to the valuation of investments, when there is intention to mislead, management bias is fraudulent in nature.

Exhibit 5-3: Examples of Significant Risks Related to Valuation Assertion

The following are examples of significant risks:

Potential Significant Risk	***Description***
Defaulted securities	The government holds securities that are considered uncollectible or have defaulted; therefore, interest should no longer be recognized. The process of determining whether securities have defaulted is complex, leading to potential misstatements in the financial statements.
Highly judgmental assumptions	The investment valuation calculations (including considerations as to whether investments are impaired) involves subjective judgments or uncertainties that may be difficult to corroborate, which increases the risk of misstatements.
Investments not actively traded	The government holds investments that are not actively traded, giving rise to market prices on similar or identical investments that may not necessarily be indicative of the investment value. The process of determining the fair value of such investments is complex and subject to uncertainties and judgment, which increases the risk of misstatements in the financial statements.

Determining Audit Strategy for Testing Investments at Fair Value

5.68 In accordance with paragraph .13 of AU-C section 540, testing how management values the investment and in responding to the assessed risks of material misstatement, as required by AU section 330, the auditor should undertake one or more of the following procedures, taking account of the nature of the accounting estimate:

a. Develop a point estimate or range to evaluate management's point estimate.

b. Test how management made the accounting estimate and the data on which it is based (including valuation techniques used by the entity in its valuations).

c. Test the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures.

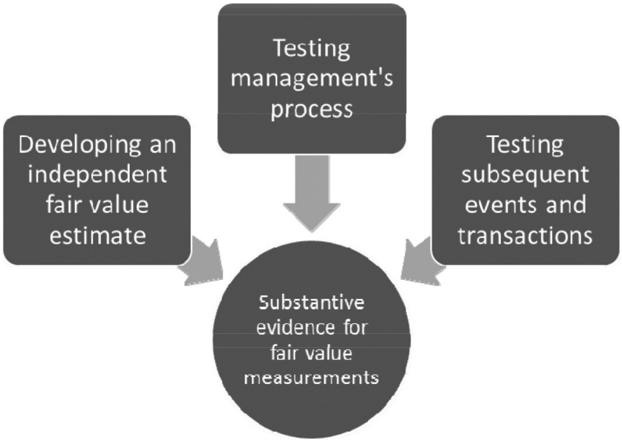
d. Determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate.

5.69 Because of the wide range of possible fair value measurements, from relatively simple to very complex, and the varying levels of risk of material misstatement associated with the process for determining fair values, the auditor's planned substantive audit procedures can vary significantly in nature, timing, and extent. This chapter has categorized three possible approaches to testing measurement (exhibit 5-4):

- Developing an independent fair value estimate
- Testing management's process
- Testing subsequent events and transactions

For investments with a higher risk of material misstatement, some auditors find that a combination of testing how management valued the investment and the data on which it is based and testing the operating effectiveness of controls will be an effective and efficient audit approach. Although subsequent events may provide some evidence about the valuation of investments, other factors may need to be taken into account to address any changes in market conditions subsequent to the date of the statement of financial position. If the auditor is unable to test how management made the estimate, the auditor may choose to develop a point estimate or range. For investments with a lower risk of material misstatement, the most effective and efficient audit approach may be to develop an independent fair value estimate.

Exhibit 5-4: Possible Approaches to Testing Measurement



5.70 Exhibit 5-5 provides considerations for each testing strategy.

Exhibit 5-5: Considerations for Each Approach to Testing Measurement

Developing an Independent Fair Value Estimate	• Generally, this approach will be more effective for Level 1 measurements and less effective for Level 3 measurements, as independent relevant and reliable audit evidence must be available to use this approach with respect to both the valuation technique and significant inputs. • Audit evidence is often obtained from pricing vendors or brokers. For many entities, Level 2 measurements may encompass various classes of securities, some of which may trade in active markets but for which there are limited sources from which independent persuasive audit evidence can be obtained. • Before selecting this substantive testing strategy, the auditor gains an understanding of both management's sources of pricing information and the availability of pricing sources independent of management's. In practice, it can be challenging to execute this testing strategy for the least liquid Level 2 securities.

Considerations for Each Approach to Testing Measurement—*continued*

	• When used for Level 3 and the least liquid Level 2 measurements, this testing strategy may involve the use of an auditor's model to independently corroborate management's valuation. Use of an auditor's model is more likely to be considered when management or management's specialist has used a proprietary model. The complexity of the model may suggest the need for the engagement team to utilize the assistance of an auditor (valuation) specialist. • This testing strategy may provide persuasive audit evidence based on the independence and objectivity of evidence obtained.
Testing Management's Process	• This testing strategy is dependent on management having a robust process to estimate fair values. • Generally, this testing strategy is more effective for Level 3 and the least liquid Level 2 measurements or when management's fair value estimation process already incorporates all of the relevant and reliable valuation sources that are available. The latter often occurs when there are relatively few vendors providing pricing information (for example, certain less liquid municipal bonds). • This testing strategy typically involves (*a*) an evaluation of the adequacy of the design of management's process in determining fair value estimates, (*b*) testing the accuracy of the pricing information used within management's process, and (*c*) performing appropriate substantive tests over the reliability and accuracy of the inputs through accumulation of corroborative evidence, the appropriateness of the valuation methodology, and the mathematical accuracy of the resulting output (for example, dual-purpose control testing, back-testing, and subsequent transaction testing).

(continued)

Considerations for Each Approach to Testing Measurement—*continued*

	• When designing audit procedures under this substantive testing strategy, auditors are reminded that the evidence obtained is to be substantive in nature. Generally, re-performance of management's process, including tests of controls, does not provide sufficient independent substantive audit evidence. • Audit evidence from this approach may be less persuasive if all of the evidence is obtained from management's process versus independently obtained. Auditors are reminded to achieve the appropriate balance of management provided evidence and independently obtained evidence. • This testing strategy often facilitates an understanding of management's process and controls and enables the engagement team to provide enhanced feedback to management.
Testing Subsequent Events and Transactions	• To use this testing strategy, purchases, sales, or other relevant transactions must have occurred and evidence of those transactions must be available. • This testing strategy can provide persuasive audit evidence if the subsequent events or transactions reflect circumstances that existed as of the measurement date. • The nature of this testing strategy makes it difficult to plan (prior to the measurement date) to use the strategy. • This testing strategy may leverage procedures that are otherwise required to be performed before the audit report release date (for example, required consideration of subsequent events information).

Management's Specialist and the Use of Others in Fair Value Measurement

5.71 Management may use others to assist in developing fair value measurements. Although management may outsource certain activities associated with fair value measurements, management cannot outsource its responsibility for the determination of fair value measurements and disclosures. Taking responsibility for the valuation of assets and liabilities measured at fair value requires that management obtain a sufficient understanding of the assets and liabilities and the methods and significant assumptions employed by outside sources to derive fair value estimates.

5.72 To estimate the fair value of investments, management may do the following:

- Utilize information from third-party pricing sources
- Gather data to develop its own estimate using various techniques, including models
- Engage a specialist to develop an estimate

Management often may use a combination of these approaches. For example, management may have its own pricing process but use third-party pricing sources to corroborate its own values.

Audit Considerations When Management Uses a Third-Party Pricing Source

5.73 Management may make use of a third-party pricing source, such as a pricing service or broker, in valuing the entity's investments. Understanding how management uses the information and how the pricing service operates assists the auditor in determining the nature and extent of audit procedures needed.

Emphasis Point

Using the same pricing source as management generally may not provide relevant and reliable audit evidence for fair value measurement.

5.74 The following matters may be relevant when management uses a third-party pricing source:

- *The type of services provided by third-party pricing source.* Some third-party pricing sources make more information available about their process. For example, a pricing service often provides information about its methodology, assumptions, and data in valuing investments at the asset class level. By contrast, brokers often provide no, or only limited, information about the inputs and assumptions used in developing the quote.
- *The nature of inputs used and the complexity of the valuation technique.* The reliability of prices from third-party pricing sources varies depending on the observability of inputs (and, accordingly, the level of inputs in the fair value hierarchy) and the complexity of the methodology for valuing a specific security or asset class. For example, the reliability of a price for an equity investment actively traded in a liquid market is higher than that of a corporate bond

traded in a liquid market that has not traded on the measurement date, which, in turn, is more reliable than that of an asset-backed security that is valued using a discounted cash flow model.

- *The reputation and experience of the third-party pricing source.* For example, a third-party pricing source may be experienced in a certain type of investment and be recognized as such but may not be similarly experienced in other types of investments. The auditor's past experience with the third-party pricing source may also be relevant in this regard.
- *The objectivity of the third-party pricing source.* For example, if a price obtained by management comes from a counterparty, such as the broker who sold the investment to the entity, or an entity with a close relationship with the entity being audited, the price may not be reliable. Conversely, pricing obtained from a custodian or trustee that is not party to or otherwise incentivized by investment transactions may be more objective and, thus, more reliable than the broker who sold the investment.
- *The entity's controls over the use of third-party pricing sources.* The degree to which management has controls in place to assess the reliability of information from third-party pricing sources affects the reliability of the fair value measurement. For example, management may have controls in place to
  - — review and approve the use of the third-party pricing source, including consideration of the reputation, experience, and objectivity of the third-party pricing source;
  - — determine the completeness, relevance, and accuracy of the prices and pricing-related data.

5.75 Possible approaches to gathering evidence regarding information from third-party pricing sources may include the following:

- For level 1 inputs, comparing the information from third-party pricing sources with observable market prices
- Reviewing disclosures provided by third-party pricing sources about their controls and processes, valuation techniques, inputs, and assumptions
- Testing the controls that the user management has in place to assess the reliability of information from third-party pricing sources
- Performing procedures at the third-party pricing source to understand and test the controls and processes, valuation techniques, inputs, and assumptions used for asset classes or specific investments of interest
- Evaluating whether the prices obtained from third-party pricing sources are reasonable in relation to prices from other third-party pricing sources, the entity's estimate, or the auditor's own estimate
- Evaluating the reasonableness of valuation techniques, inputs, and assumptions
- Developing a point estimate or range for some investments priced by the third-party pricing source and evaluating whether the results are within a reasonable range of each other

- Obtaining a service auditor's report that covers the controls over validation of the prices[3]

5.76 Obtaining prices from multiple third-party pricing sources may also provide useful information about measurement uncertainty. A wide range of prices may indicate higher measurement uncertainty and suggest that the investment is sensitive to small changes in data and assumptions. A narrow range may indicate lower measurement uncertainty and suggest less sensitivity to changes in data and assumptions. Although obtaining prices from multiple sources may be useful, when considering investments that have inputs categorized at levels 2 or 3 of the fair value hierarchy, in particular, obtaining prices from multiple sources may not provide sufficient appropriate audit evidence on its own because:

- What appear to be multiple sources of pricing information may be utilizing the same underlying pricing source.
- Understanding the inputs used by the third-party pricing source in determining the price may be necessary in order to categorize the investment in the fair value hierarchy.

5.77 In some situations, the auditor may be unable to gain an understanding of the process used to generate the price, including any controls over the process of how reliably the price is determined, or may not have access to the model, including the assumptions and other inputs used. In such cases, the auditor may decide to undertake to develop a point estimate or range to evaluate management's point estimate in responding to the assessed risk.

Emphasis Point

When using third-party pricing services for fair value information, management remains responsible for:

- Complying with GAAP, including disclosure requirements;
- Maintaining appropriate internal controls to prevent or detect and correct material misstatements related to fair value measurements and disclosures;
- Maintaining accurate books and records even if it uses a vendor.

To execute management's responsibilities, entities that use third-party pricing vendors for estimating the fair value of investment securities generally have processes in place to both (*a*) develop an understanding of a vendor's pricing methodologies, and (*b*) design and implement specific internal controls over the valuation of securities.

Meeting these responsibilities is generally more challenging for security pricing information obtained from a large volume vendor when the item being valued is subject to a greater degree of valuation uncertainty. Increased subjectivity is usually present in the less liquid and harder-to-value securities classified within Level 2 and Level 3 of the fair value hierarchy. Conversely, meeting these responsibilities is generally less challenging for securities with

[3] Some pricing services may provide reports for users of its data to explain their controls over pricing data (that is, a report prepared in accordance with AT-C section 320, *Reporting on an Examination of Controls at a Service Organization Relevant to User Entities' Internal Control Over Financial Reporting* [AICPA, *Professional Standards*]). Management may request, and the auditor may consider obtaining, such a report to develop an understanding of how the pricing data is prepared and to evaluate whether the controls at the pricing service can be relied upon.

a readily determinable fair value classified within Level 1 of the fair value hierarchy and the more liquid securities classified within Level 2, valued using a market approach.

Management may begin its fair value measurement efforts by obtaining an understanding of a vendor's valuation methodologies. This allows management to develop the basis for identifying and responding to risks of material misstatement related to estimating fair value measurements. Management considerations within this risk assessment process may include evaluating the (*a*) type, nature, and complexity of securities; (*b*) activity level in the market for the type of securities; and (*c*) availability of market data. An appropriate understanding of the valuation risks allows management to respond by developing internal controls that appropriately mitigate the risks identified.

Based on the evaluation as to the adequacy of internal controls over the use of information obtained from third-party pricing vendors in estimating fair values, the auditor should determine if an internal control deficiency exists, and whether such deficiency rises to the level of a significant deficiency or material weakness.

Additional Considerations About Alternative Investments

5.78 Alternative investments represent investments for which a readily determinable fair value does not exist (that is, investments not listed on national exchanges or OTC markets or for which quoted market prices are not available from sources such as financial publications, the exchanges, or NASDAQ). These investments include private investment funds meeting the definition of an investment company under the provisions of the AICPA Audit and Accounting Guide *Investment Companies*, such as hedge funds, private equity funds, real estate funds, venture capital funds, commodity funds, offshore fund vehicles, and funds of funds, as well as bank common or collective trust funds. Alternative investments may be structured as limited partnerships, limited liability corporations, trusts, or corporations.

5.79 The valuation assertion related to alternative investments required to be accounted for at fair value may involve significant judgment by management in the assessment of the estimate of fair value of the investment. The more complex or illiquid the investment or the lack of sufficient management processes and records over valuation, the greater the risk of misstatement and the more persuasive audit evidence needs to be obtained by the auditor.

5.80 The auditor's understanding of the reliability of the process used by management to determine estimated fair value is an important element in support of the resulting amounts and, therefore, affects the nature, timing, and extent of audit procedures. The auditor may test management's fair value estimate as of the date of the statement of financial position by using one or more of the following approaches. The approach(es) taken may not be the same for all alternative investments in an investor entity's portfolio because the nature of the underlying investments and associated risk, as well as the information available to management and the auditor, likely will be different for each alternative investment. The higher the assessed risk of material misstatement, the greater the need for the auditor to utilize a combination of the following approaches:

- *Confirm the alternative investment.* If the auditor determines that the nature and extent of auditing procedures includes testing the measurement of the investor entity's investment, simply receiving a confirmation from the alternative investment of the entity's underlying investments, either in aggregate or on a security-by-security basis, does not, in and of itself, constitute sufficient appropriate audit evidence in addressing the valuation assertion. The extent of the additional audit procedures is directly related to the assessed risk of material misstatement of the financial statements.

- *Review and test the investor entity's significant assumptions and the underlying data in its valuation or analysis of the assumptions and data obtained from the fund manager.* A confirmation on a security-by-security basis may provide support of the data used by the investor's management in its valuation process. In drafting a confirmation, the auditor may consider requesting a description of each investment, ownership percentage or shares owned, and estimated fair value. If detailed information is not available, the auditor may look to the other data that management used in its valuation and perform tests on such data. The nature of the tests depends on the types of data used by management and the auditor's assessment of the risk of material misstatement of the financial statements.

- *Reconcile to audited financial statements as of the same date.* If audited financial statements of the alternative investment are available as of the date of the investor entity's year-end, and the alternative investment follows fair value accounting, the audited financial statements and an accompanying auditor's report may provide significant audit evidence regarding the valuation of the investment. However, the investor entity and fund often have different fiscal year-ends. In lower- or moderate-risk situations, the auditor might be able to obtain the fund's audited financial statements as of the fund's fiscal year-end and perform (or arrange to have the fund's auditor perform) additional procedures to test the transactions and changes in fair value between the fund's fiscal year-end and the investor's fiscal year-end.

- *Review transactions at or near the date of the statement of financial position*. Evidence of an actual transaction, such as an investment in, or liquidation of, a portion of its alternative investment as of a date close to the investor entity's fiscal year-end, may provide information for management to support the valuation of the alternative investment. The auditor may consider how often settlements occur and the terms used to determine the value of the settlement. Issues to consider include whether the process used for the settlement is the same process used for financial reporting; whether there are holdbacks or potential true-ups subsequent to the date of the statement of financial position; and the possibility that the parties to the transactions were not both willing buyers and sellers, such as in a distress sale.

5.81 If management estimates the fair value of a significant portion of its alternative investments as of an interim date, management will need a robust process and strong internal control over the roll-forward period to the date of the statement of financial position. Because the valuation assertion embedded in the financial statements is as of the date of the statement of financial position, management needs to have the ability to obtain sufficient information to record the investments at estimated fair value as of the date of the statement of financial position, including changes in the estimated fair value during the roll-forward period. In this situation, the auditor may test both the estimation process as of the interim date and the roll-forward process.

Relevant Assertions for Investments and Investment Income

5.82 The relevant assertions for investments and investment income include the following:

a. Investments and investment transactions are initiated in accordance with the established investment policies and comply with laws, regulations, and plan or trust provisions, if applicable.

b. All investments are recorded and exist.

c. All investments are owned by the entity, free of liens, pledges, and other security interests or, if not free from security interest, whether they are identified and properly disclosed.

d. All investments are properly valued as of the entity's fiscal year-end.

e. All investment income (including net appreciation or depreciation in fair value) is accurately reported.

f. Investment disclosures are complete and accurate.

Examples of Identified Risks of What Can Go Wrong at the Relevant Assertion Level

5.83 The following are examples of identified risks of what can go wrong at the relevant assertion level relating to investments and investment income:

a. Investment information from the trustee (custodian) statements do not reconcile to the management's records (trial balance) or financial statements.

b. Investment manager or subcustodial reports do not reconcile to trustee (custodian) reports.

c. Investment transactions are not recorded by the trustee (custodian) or are not recorded on a timely basis.

d. Investments and investment income (for example, alternative investments, private equity, and real estate) are not properly recorded as of the reporting date due to a lag (for example, 90 days) in reporting information by the investment managers.

e. Investments are not properly reported based on fair value due to inappropriate valuation methodologies, mathematical errors in the application of the methodology, or inaccurate inputs.

f. Equity interests (other than investments) reported based on the equity method of accounting are not properly reported due to the financial information of the investee being misstated, errors in recognizing the appropriate percentage of the investee financial statement amounts, or not recognizing an impairment when indicators suggest that a decrease in value is appropriate.

g. Investments that should be reported at fair value are inappropriately reported as cost, and vice versa.

h. Investments reported at cost are not properly reported because premiums and discounts are not amortized.

i. Investment purchase and sale transactions are not properly authorized prior to initiation or are not in accordance with the investment policies, laws, regulations, and plan or trust provisions, if applicable.

j. Amounts due to (or due from) brokers for securities purchased or sold are not properly recorded.

k. For investments measured at other than fair value, gains and losses on sales of investments are calculated incorrectly.

l. For defined benefit pension plans administered through a trust or equivalent arrangement that meets the specified criteria, allocated insurance contracts are not properly excluded from pension plan assets based upon contract terms.

m. Financial statement disclosures are not complete or accurate.

Example Audit Procedures to Consider—All Assertions Except Valuation and Disclosure

5.84 The following list contains examples of substantive procedures that may be appropriate for auditing relevant assertions relating to the completeness, accuracy, existence, occurrence, and rights and obligations for investments:

a. Obtaining evidence regarding the existence and ownership of investments and information about any liens, pledges, or other security interests, either by direct confirmation from the trustee, custodian, or by physical inspection of the securities. The auditor may direct the confirmation request to a third party who maintains custody of the securities (existence) or who the auditor believes is knowledgeable about the other information (ownership, rights, and obligations) to be confirmed.

Emphasis Point

Entities often engage one or more external parties, including a custodian, to assist in the administration of the entity's investment portfolio. Generally, the existence of investments may only be confirmed by the holder or issuer of an investment. To identify the correct external party to confirm existence of investments, it is recommended the auditor obtain the custody agreement from the entity.

For example, certain entity's investments may be required to be held in a trust. The trustee is legally obliged to make all trust-related decisions with the entity's interest in mind, and may be liable for damages in the event of not doing so. The custodian may also serve as trustee, but not all trustees have custody of the assets.

In some cases, it is not clear as to the distinction between the investment manager and the custodian. When confirming existence of investments, paragraph .07*b* of AU-C section 505, *External Confirmations*, requires the auditor to select the appropriate confirming party (for example, the issuer or custodian, not the investment manager, investment adviser or broker [unless the investment manager, investment adviser or broker also serves as custodian for the investment securities]). It may be necessary to confirm with the issuer when there is no custodian, for example, when the entity holds privately offered securities or real estate.

Emphasis Point

Confirmation of investments may provide audit evidence relevant to various assertions; however, the amount of audit evidence obtained is not the same for each relevant assertion. Obtaining a confirmation from a third party (for example, investee, custodian, trustee) of the entity's investment (or a portfolio of investments), either in aggregate or on a security-by-security basis, does not, in and of itself, constitute sufficient appropriate audit evidence with respect to the valuation assertion.

b. Reviewing minutes and agreements to determine if investment policies were followed.

c. Obtaining a list of investments and testing investment transactions as follows:

  i. Determining that investment transactions were properly authorized

  ii. Examining brokers' advices, cash records, and other supporting documentation for the cost, selling price, quantity, identification, and dates of acquisition and disposal of the investments[4]

Emphasis Point

Because most trading functions among investment managers, brokers, and trade settlement or clearing organizations are automated, testing approaches would vary depending upon the availability of online or external documentation maintained. For proper control and documentation retention, most investment advisers maintain a listing of trades executed. Often, trade details can be traced to online records that include matching broker and settlement confirmation. This same detail is often available in summary statements or other means that are maintained by the investment adviser.

Type 2 SOC 1® reports for the trustee or custodian include a description and testing of controls surrounding investment transactions and can be useful in determining the scope of testing in this area but do not, in and of themselves, provide sufficient appropriate evidence.

  iii. Comparing prices at which purchases and sales were recorded with published market price ranges on the trade dates

  iv. Recalculating net appreciation or depreciation in fair value

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[4] The accrual basis of accounting requires that purchases and sales of securities be recorded on a trade-date basis.

d. When necessary to test the purchases and sales of investments, obtaining a roll-forward schedule of investments and performing the following procedures:

   i. Verifying the mathematical accuracy of the roll-forward schedule

   ii. Performing substantive tests over the components of the roll-forward, including purchases and sales of investments

   iii. Agreeing opening balances to the prior period roll-forward schedule

   iv. Agreeing the ending balances to the general ledger or other appropriate schedule and to the financial statements

e. Obtaining and testing management's reconciliation of the investment records of the custodian and investment manager with the general ledger.

f. Confirming with the trustee, custodian, investment manager, or broker the status of any securities that are in transit.

g. Testing investment income, which may include testing a sample of dividends and interest earned during the period; applying substantive analytical procedures; or a combination of both. In testing a sample of dividends for publicly traded securities, the auditor might consult independent financial reporting services to determine the ex-dividend and payable dates and the rates for the securities selected for testing. Interest payment dates and rates are also available from such services.

h. Determining whether accrued investment income during the period has been properly recorded.

Example Audit Procedures to Consider—Valuation

5.85 The following paragraphs contain examples of substantive procedures that may be appropriate for auditing the valuation assertion for investments.

Investments Reported Under a Cost-Based Measure

5.86 The following are examples of substantive audit procedures for investments reported under a cost-based measure:

a. Determining whether the investment meets the criteria for reporting using a cost-based measure as discussed in paragraph 69 of GASB Statement No. 72.

b. Examining brokers' advices, cash records, and other supporting documentation for the cost, selling price, quantity, identification, and dates of acquisition and disposal of the investments.

c. Recalculating discounts and or premiums and related amortization, if applicable.

d. Recalculating the accretion of interest, if applicable.

Equity Interests (Other Than Investments) Reported Under Equity Method

5.87 The following are examples of substantive audit procedures for investments (common stock) reported under the equity method:

Emphasis Point

An investment accounted for under the equity method constitutes a component for purposes of AU-C section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* (AICPA, *Professional Standards*). The procedures that follow assume the equity method investment represents a significant component.

a. Determining whether the investment (common stock) meets the criteria for equity method accounting included in paragraphs 205–208 of GASB Statement No. 62.

Emphasis Point

In accordance with paragraph 77 of GASB Statement No. 72, investment (common stock) held by external investment pools, pension or OPEB plans, IRC Section 457 deferred compensation plans, and endowments or permanent funds are *excluded* from using the equity method of accounting.

b. Obtaining and reading the investee entity's most recent audited financial statements, preferably as of the investor's date of the statement of financial position, and consider:

   i. Differences between the financial reporting framework of the investee entity's audited financial statements and the framework applied by the investor.

   ii. The nature of the investee's financial statements audit opinion. For example, if the opinion is modified, whether the modified auditor's report has implications relative to the usefulness of the investee's historical financial information.

c. When the group auditor makes reference to the component auditor for an equity method investment in the auditor's report on group financial statements, applying the requirements of AU-C section 600, including

   i. Determining whether the report of the other auditor is satisfactory for the purpose of the group audit.

   ii. Communicating the group auditor's requirements to a component auditor, including

      (1) a request that the component auditor, knowing the context in which the group engagement team will use the work of the component auditor, confirm that the component auditor will cooperate with the group engagement team;

      (2) the ethical requirements that are relevant to the group audit and, in particular, the independence requirements;

      (3) a list of related parties prepared by group management and any other related parties of which the group engagement team is aware; and

(4) identified significant risks of material misstatement of the group financial statements, due to fraud or error that are relevant to the work of the component auditor.

iii. Obtaining communication from component auditor that it has complied with ethical requirements relevant to the group audit, including independence and professional competence.

iv. Performing procedures designed to identify events at those components that occur between the dates of the financial information of the components and the date of the auditor's report on the group financial statements and that may require adjustment to, or disclosure in, the group financial statements.

Emphasis Point

If the group auditor assumes responsibility for the work of a component auditor of an equity method investment, the group auditor should perform additional procedures as described in paragraphs .51–.65 of AU-C section 600.

d. Obtaining a roll-forward schedule of each equity investment and performing the following procedures:

i. Verifying the mathematical accuracy of the roll-forward schedule.

ii. Performing substantive tests over the components of the roll-forward, including investment purchases and sales of investments, impairments, recognition of the investor's share of the investee's earnings, return of capital distributions, dividends, as well as other changes in the investee's net assets.

iii. Agreeing the opening balances to the prior period roll-forward schedule.

iv. Agreeing the ending balances to the general ledger or other appropriate schedule and to the financial statements.

e. If the audited financial statements of the investee are as of a date other than the investor entity's financial reporting date, consider performing the following procedures, in addition to those listed previously, to test the valuation of the investment:

i. obtaining an understanding of management's process and controls intended to assess and monitor the reliability of historical information provided by the investee

ii. obtaining and reading the investee entity's relevant unaudited financial information and comparing to the information used by management in determining the valuation of the investment, and

(1) performing analytical comparisons of the financial information to corresponding information from previous periods.

(2) Evaluating the reasonableness of adjustments investor management made to the investee's historical information to compensate for the different audited financial statement dates, or evaluate whether management's basis for not making any adjustments is reasonable.

(3) reading the relevant information in the investor's files relating to the investee, such as investee minutes and budgets and cash flow information related to the investee. Determine whether the information included in those files is consistent with management's use of the investee entity's unaudited financial information.

(4) comparing the unaudited historical financial results of the investee used in the prior period valuation to subsequently obtained audited financial information.

(5) confirming with investee management the unaudited financial information used by management to determine the valuation of the investment.

(6) inquiring of investor management (including investor management delegate that sits on the board or governing body of the investee entity, if applicable) about investee's unaudited financial information and determine whether

  (a) the unaudited financial information is consistent with investor management's understanding of the investee's financial performance;

  (b) the investor management is aware of any matters that may negatively impact the reliability of the investee's unaudited financial information.

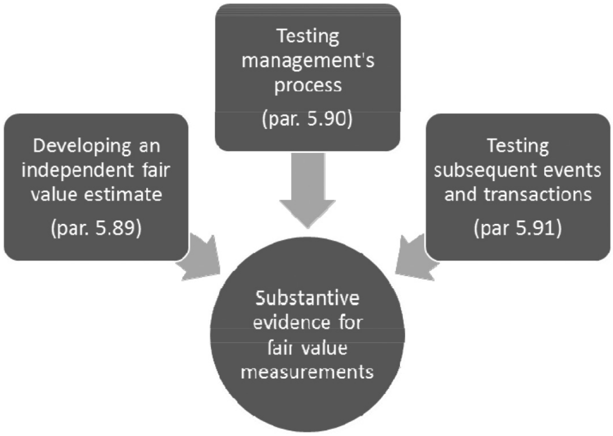
(7) performing substantive analytical procedures to compare the investee's most recent audited financial statements to the financial information used by management in determining the valuation of the investment, considering changes to the underlying value and composition of investments and market conditions.

(8) documenting findings and conclusion relative to the reasonableness, relevance and reliability of the unaudited historical financial information for its intended purpose.

f. Determining whether a series of operating losses of an investee or other factors may indicate that a decrease in value of the investment has occurred that is other than temporary and that shall be recognized even though the decrease in value is in excess of what would otherwise be recognized by application of the equity method.

Investments Reported at Fair Value

Exhibit 5-6: Possible Approaches to Testing Measurement



5.88 The following are examples of substantive audit procedures for investments reported at fair value when the auditor is developing an independent fair value estimate:

a. Establishing a point estimate or an acceptable range of prices against which management's estimate will be evaluated, taking into consideration the estimation uncertainty as well as market factors indicative of the possible estimation uncertainty.

> **Emphasis Point**
>
> It may be appropriate for some exchange-traded equity securities to compare a single price obtained from a source different than the source used by management. For other types of investments, such as those with fewer observable or unobservable inputs, it may be appropriate to compare the auditor's point estimate to a range of prices determined as a percentage, plus or minus, of management's point estimate.
>
> A range of acceptable price estimates may be based on a number of factors, including the nature of the security, the assessed risk related to the underlying assets (if applicable), and current trading characteristics of similar investment securities. Generally, acceptable ranges are narrower for investment securities presenting lower estimation uncertainty and wider for those presenting greater estimation uncertainty. Information that may be useful to the auditor in establishing an acceptable range include the individual security or market bid-ask spreads, transaction price levels, implied volatility, level of activity, and observation of whether there is any market disruption.

b. Identifying the source of the pricing information and determining whether the source is the same as that used by management. Pricing information received from the same source as management is generally less persuasive except for exchange-traded securities for which the information is based on pass-through prices.

> **Emphasis Point**
>
> Prices provided by the dealer (broker) from which management purchased the investment are considered in a manner consistent with that for prices provided by pricing services. However, because dealers typically do not accept responsibility for and accuracy for the information provided, the audit evidence is less persuasive.
>
> Using the same pricing source as management does not provide an independent fair value measurement except for exchange-traded securities for which the information is based on pass-through prices.

c. Assessing the external source's experience in providing valuations in order to assess reliability of the audit price.

d. Documenting the source and rationale for the range of acceptable prices selected.

e. Comparing the point estimate or range of independent estimates developed against management's fair value estimate.

f. In instances where the point estimate is unreasonably outside of management's fair value estimate, consider whether there is evidence of management bias.

g. Assessing the competence and objectivity of management's expert in providing valuations for the estimate subject to testing, propriety of methodologies employed, and reasonableness of the assumptions used to determine reliability of the audit price.

h. Comparing transactions to historical estimates from the audit source (back-testing) to assess reliability of the audit price.

5.89 The following are examples of substantive audit procedures for investments reported at fair value when the auditor is testing management's process:

> **Emphasis Point**
>
> Testing management's process often consists of evaluating the reasonableness of the separate components of management's fair value measurement and disclosure, specifically (*a*) assumptions, (*b*) the underlying data, and (*c*) the valuation model, additional considerations may be necessary. The acceptable range for each assumption depends on the estimation uncertainty inherent in the particular assumption, the complexity of the model, and external market factors.

a. Identifying those assumptions and inputs that could significantly affect the fair value estimate that will be tested based on the understanding of management's valuation methodology, the nature of the fair value measurement, the estimation uncertainty, and the interdependencies of the underlying inputs and assumptions.

b. Assessing the relevance and reliability of all significant assumptions and inputs obtained from sources *internal* to the entity to determine whether the information on which the assumption may be based is appropriate for the testing approach, including the following:

i. Obtaining audit evidence about the accuracy and completeness of internally generated information

ii. Evaluating whether the information is sufficiently precise and detailed for audit purposes

iii. Evaluating the consistency of the assumption with similar forecasts or assumptions used for planning and budgeting and as approved by the board of directors or others charged with governance

iv. Evaluating market indicators and determine that management's significant assumptions are reasonable and reflect, or are not inconsistent with, market information

c. Assessing the relevance and reliability of all significant assumptions and inputs obtained from *external* sources to determine whether the information on which the assumption may be based is appropriate for the testing approach, including the following:

i. Obtaining audit evidence about the accuracy and completeness of externally generated information

ii. Evaluating whether the information is sufficiently precise and detailed for audit purposes

iii. Evaluating the consistency of the assumption with similar forecasts or assumptions used for planning and budgeting and as approved by the board of directors or others charged with governance

iv. Evaluating market indicators and determine that management's significant assumptions are reasonable and reflect, or are not inconsistent with, market information

d. Establishing and documenting the range of acceptable points for each assumption.

e. Evaluating the competence and objectivity of management's third-party specialist, where applicable.

f. Testing mathematical accuracy of the model and the appropriate application of the model by management.

5.90 The following are examples of substantive audit procedures for investments reported at fair value when the auditor is testing subsequent events and transactions:

Emphasis Point

Relevant events and transactions after the date of the statement of financial position but before the date of the auditor's report may provide persuasive audit evidence regarding management's fair value estimate.

a. Reviewing relevant subsequent events and transactions to determine if any comparable transactions exist

b. Obtaining information regarding executed client transactions on or around the measurement date for the same, or substantially the same, investments

c. Assessing the relevance and reliability of comparable subsequent transactions

Example Audit Procedures to Consider—Investment Related Disclosures

5.91 The following are examples of substantive audit procedures relating to investment disclosures:

a. Evaluating whether investment fair value disclosures required by GASB Statement No. 72 have been appropriately disaggregated, based on the criteria in paragraph 80 of GASB Statement No. 72

b. Reconciling totals by asset class of the investment fair value disclosures to supporting schedules provided by management and test work performed over valuation

c. Evaluating whether management has properly assigned fair value hierarchy levels (Level 1, Level 2, or Level 3) to investments

Emphasis Point

The fair value hierarchy level for investments within the scope of paragraphs 71–74 of GASB Statement No. 72 that are measured at NAV per share or its equivalent is *not* required to be disclosed.

In some cases, particularly for exchange-traded and actively traded securities with observable inputs, the auditor's evaluation of management's assignment of investments to the fair value hierarchy may consider evidence obtained from testing the fair value of individual securities. In other words, pricing information obtained by the auditor from an independent pricing source (such as a pricing vendor) may provide corroborating evidence that management has appropriately assigned fair value hierarchy levels. However, it is important to note that pricing vendors do not provide conclusions relative to fair value hierarchy designations.

d. Determining the completeness and accuracy of disclosures required by paragraph 82 of GASB statement No. 72 for investments that are measured at NAV per share

e. Determining the completeness and accuracy of credit risk, interest rate risk, and foreign currency risk disclosures required by GASB Statement No. 40

f. For defined benefit pension plans administered through a trust or equivalent arrangement that meets the specified criteria, determining whether the annual money-weighted rate of return on pension plan investments has been properly calculated and disclosed in accordance with GASB Statement No. 67, as amended

g. Determining whether the disclosures in the financial statements related to accounting estimates are appropriate. For accounting estimates that give rise to significant risks, evaluating the adequacy of the disclosure of estimation uncertainty in the financial statements. See paragraphs .19–.20 of AU-C section 540.

Example Audit Procedures for Certain Specific Types of Investments

5.92 The following paragraphs include additional considerations for specific types of investments.

Auditing Alternative Investments

5.93 Alternative investments can present challenges with respect to obtaining sufficient appropriate audit evidence in support of the existence and valuation assertions because of the lack of a readily determinable fair value for these investments and the limited investment information generally provided by fund managers.

5.94 When auditing alternative investments, it is important to understand management's process related to valuation. This includes, but is not limited to, determining the nature of the underlying investments, understanding how often management interacts with fund manager(s) of such investments, the availability of audited financial statements for such investments, and Type 2 SOC 1 reports on the determination of unit values of such investments. Obtaining a confirmation from the trustee, custodian, or investment manager that contains fair values does not constitute valuation testing.

5.95 The following are examples of substantive audit procedures relating to specific types of investments that may be performed to accumulate evidence for relevant assertions.

<u>Auditing Direct Investments in Real Estate</u>

5.96 The following are examples of substantive audit procedures relating to real estate investments that may be performed to accumulate evidence for relevant assertions:

a. Examining closing and other documents supporting the cost of the real estate

b. Examining deeds, title policies, encumbrances, and other evidence related to ownership

c. Testing fair value. If an outside valuation specialist has been engaged by either management or the auditor (such as a real estate appraiser), paragraph .08 of AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*), or paragraph .09 of AU-C section 620, *Using the Work of an Auditor's Specialist* (AICPA, *Professional Standards*), as applicable, applies with regard to performing appropriate tests of the accounting data provided to the specialist and reviewing the specialist's competence, capabilities, and objectivity.

d. Examining current-year tax bills and relating them to property descriptions under item *b*

e. Testing investment income from real estate (such as rents) and payments of related expenses, such as taxes and maintenance

f. Inquiring of management whether investments or other transactions violate applicable laws and regulations

<u>Other Alternative Investments (Such as Limited Partnerships, Hedge Funds, Offshore Partnerships, Private Equity, or Venture Capital Funds)</u>

5.97 The following are examples of substantive audit procedures relating to other alternative investments that may be performed to accumulate evidence for relevant assertions:

a. Obtaining confirmation of the entity's holdings in the alternative investments from the investment manager, adviser, or general partner (including activity during the year and percentage ownership and a request to provide a listing of all underlying investments held). *Note*: Confirmation does not constitute adequate audit evidence regarding valuation.

b. Obtaining a copy of audited financial statements for the alternative investment and year-end capital allocation schedule from the investment manager or adviser and relating reasonableness of the alternative investment value reported in the financial statements and allocation schedule to the alternative investment value recorded by the government, including fair value, purchases and sales value, income earned, and income accrued.

c. If the alternative investment is not audited as of the same date of the government's year-end or if the auditor's report on the alternative investment is not satisfactory, further auditing procedures may include the following:

   i. Obtaining a copy of the alternative investment holdings and inquiring of management regarding the methods for valuation

   ii. Obtaining a copy of the appraisal (refer to AU-C section 500 or 620, as applicable) or performing valuation procedures

   iii. Obtaining an understanding of the alternative investment controls and assessing control risk relating to the alternative investment

   iv. If there is a significant gap between the date of the audited financial statements and the government's year-end, consider the following:

      (1) Obtaining interim financial information and testing a roll-forward of transactions from the date of the financial statements to the government's year-end

      (2) Testing management's tracking analysis of the investment

      (3) Comparing prior year's estimated values to actual results to assess the reliability of current year information

d. Examining documents approving and supporting selected investment purchase and sale transactions (such as subscription and redemption documentation, investment agreement, and minutes of meetings)

e. Reviewing minutes, agreements, and confirmations for evidence of liens, pledges, or other security interest in investments

f. Performing tests of investment transactions that may include the following:

   i. Examining evidence that they were properly authorized

   ii. Examining cash disbursement records or other supporting documentation for the historical cost or selling price, quantity, identification, and date of acquisition and disposal

   iii. Agreeing prices at which purchases and sales were recorded to supporting evidence (including information provided by an outside specialist, if applicable) for price ranges on the trade dates

iv. Checking the computation of the net change in appreciation or depreciation in fair value

g. Testing the fair value of investments, in accordance with AU-C section 501, *Audit Evidence—Specific Considerations for Selected Items* (AICPA, *Professional Standards*), or AU-C section 540, as applicable. If an outside valuation specialist has been engaged, perform appropriate tests of the accounting data provided to the specialist. Review the specialist's competence, capabilities, and objectivity in accordance with paragraph .08 of AU-C section 500 or paragraph .09 of AU-C section 620, as applicable.

h. Inquiring of management whether investments or other transactions violate applicable laws and regulations

Auditing Securities Lending Activities

5.98 The following are examples of substantive audit procedures relating to securities lending:

a. Reviewing the securities lending agreement for a description of securities lending activities

b. Evaluating whether securities lending activities are in accordance with applicable laws, plan or trust provisions, if applicable, and investment policies

c. Reviewing the confirmation from the trustee (custodian) to identify the following:

i. Securities on loan

ii. Collateral received (either cash or securities)

iii. If the entity received cash, the securities for which the cash collateral was invested.

d. Testing the valuation of securities on loan and collateral received (either cash or securities)

e. Evaluating whether the security lending collateral (cash and investments for which the government has the ability to sell or pledge) and the corresponding liability to return the collateral are properly recorded in the statement of net position

f. Testing that securities lending income was recorded accurately and in the proper period

g. Evaluating whether disclosures for securities lending activities are complete and accurate

Auditing Allocated Contracts for Defined Benefit Pension Plans Administered Through Trusts or Equivalent Arrangements That Meet The Specified Criteria

5.99 When allocated contracts are used to pay benefits, these contracts should be excluded from plan assets if the contract meets certain criteria as discussed in paragraph 19 of GASB Statement No. 67. The following are examples of substantive audit procedures related to allocated insurance contracts:

a. Obtaining and reading the contract between the issuers and the plan to verify plan management's analysis of the proper accounting treatment in accordance with paragraph 19 of GASB Statement No. 67

b. Determining that annuity purchases were made on the basis of rates stipulated in the contract. If annuities are not purchased, and benefits are paid directly from plan assets, benefit payments may be tested in accordance with the guidance on recurring (annuity) payments in chapter 13 of this guide.

Part II—Accounting, Financial Reporting, and Auditing Considerations for Derivative Instruments

Nature of Transactions

5.100 Derivative instruments are often complex financial arrangements used by governments (*a*) as investments, (*b*) as hedges of identified financial risks associated with assets or liabilities or expected transactions, or (*c*) to lower the costs of borrowings. Common types of derivative instruments governments enter into include the following:

- Interest rate and commodity swaps
- Interest rate locks
- Options (calls, puts, caps, floors, and collars)
- Swaptions
- Forward contracts
- Futures contracts

5.101 Historical prices are zero for many derivative instruments because their terms are developed such that the instruments are entered into without a payment being made or received. During the term of a derivative instrument, a government receives and makes payments based on market prices without actually entering into the related financial or commodity transactions. Derivative instruments associated with changing financial and commodity prices result in changing cash flows and fair values that can be used as effective risk management or investment tools. However, derivative instruments can expose governments to significant risks and liabilities (see paragraphs 5.111–.112).

5.102 GASB Statement No. 53, as amended, defines a *derivative instrument* as a financial instrument or other contract with all three of the characteristics in the following list:

- *Settlement factors.* It has (*a*) one or more reference rates and (*b*) one or more notional amounts or payment provisions or both. Those terms determine the amount of the settlement or settlements and, in some cases, whether or not a settlement is required. (GASB IG 2015-1 question 10.4.1 discusses settlement factors.)
- *Leverage.* It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. (GASB IG 2015-1 questions 10.5.1–10.5.2 discuss leverage.)
- *Net settlement.* Its terms require or permit net settlement, it can readily be settled net by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position

not substantially different from net settlement. (GASB IG 2015-1 questions 10.6.1–10.6.6 discuss net settlement.)

Investment Derivative Instruments

5.103 A derivative instrument that (*a*) is held primarily for the purpose of income or profit and (*b*) has a present service capacity based solely on its ability to generate cash or to be sold to generate cash is an investment derivative instrument. In addition, a derivative instrument that does not meet the criteria of a hedging derivative instrument (see paragraph 5.104) is considered an investment derivative instrument.

Hedging Derivative Instruments

5.104 There are a number of assets, liabilities, and expected transactions that expose a government to the risk of adverse changes in cash flows and fair values. Hedging is one method that governments employ to reduce identified financial risks (for example, to counter increases in interest costs, to offset price increases in the acquisition of commodities, or to protect against fair value losses). Derivative instruments utilized in hedging relationships are designed to reduce identified financial risks by offsetting changes in cash flows or fair values of the associated item.

5.105 A derivative instrument that is associated with a hedgeable item but has yet to be determined effective in significantly reducing the identified financial risk is referred to as a *potential hedging derivative instrument*. A hedging derivative instrument is established if both of the following criteria are met:

a. The derivative instrument is associated with a hedgeable item. Association is established by consideration of the facts and circumstances of the derivative instrument, including whether

  i. the notional amount of the derivative instrument is consistent with the principal amount or quantity of the hedgeable item;

  ii. the derivative instrument will be reported in the same fund, if applicable, as the hedgeable item; and

  iii. the term or time period of the derivative instrument is consistent with the term or time period of the hedgeable item.

b. The potential hedging derivative instrument is effective in significantly reducing the identified financial risk. Effectiveness is established if the changes in cash flows or fair values of the potential hedging derivative instrument substantially offset the changes in cash flows or fair values of the hedgeable item.

Hybrid Instruments

5.106 A derivative instrument also may accompany a companion instrument such as a debt instrument, a lease, an insurance contract, or a sale or purchase contract. An embedded derivative instrument may be a call option in a bond,[5] a cap or floor in a sale or purchase contract, or an interest rate swap

[5] GASB IG 2015-1 question 10.6.1 states that bonds with an embedded call option where the potential settlement of the government's obligation to the creditor that would occur upon exercise of the call option meet the net settlement criteria. However, GASB IG 2015-1 question 10.6.1 also states that in many cases, the economic characteristics and risks of the embedded option and the bonds are closely related, and separate reporting of the embedded option and the bonds is not required.

in a debt instrument. Alternatively, some derivative instruments may include investing or borrowing transactions. These instruments may give rise to hybrid instruments, which consist of a derivative instrument and a companion instrument.

5.107 A hybrid instrument exists when the instrument meets all of the following criteria:

- The companion instrument is not measured on the statement of net position at fair value.
- A separate instrument with the same terms as the derivative instrument would meet the definition of a derivative instrument.
- The economic characteristics and risks of the derivative instrument are not closely related to the economic characteristics and risks of the companion instrument. This would be the case in any of the following circumstances:
  - — Up-front payment is received because the derivative instrument has off-market terms.
  - — Written option that is in-the-money (that is, the option has intrinsic value) but the initial intrinsic value of the written option is not closely related to the characteristics and risks of the derivative instrument.
  - — Reference rate is inconsistent with the market of the companion instrument.
  - — Hybrid instrument could be settled in such a way that an investor would not recover substantially all of its investment (that is, potential negative yield).
  - — Yield of the companion instrument is leveraged. Leveraged yield occurs when the embedded derivative instrument meets both of the following criteria:
- The holder's initial rate of return on the companion instrument has the potential for at least a doubled yield.
- The rate of return is at least twice what the market return would be for an instrument with the same terms as the companion instrument.

5.108 An embedded derivative instrument that is a component of a hybrid instrument is recognized and measured in accordance with GASB Statement No. 53, as amended, and discussed in this chapter. Other companion instruments are recognized and measured in accordance with the reporting requirements applicable to the companion instrument (that is, the financial reporting requirements for a debt instrument, a lease, or an insurance contract). (GASB IG 2015-1 questions 10.44.1–10.44.4 discuss accounting and reporting for hybrid instruments.)

Financial Instruments Not Included in the Scope of GASB Statement No. 53[6]

5.109 The following financial instruments are not included in the scope of GASB Statement No. 53:

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[6] GASB IG 2015-1 questions 10.8.1–10.13.9, as amended, discuss financial instruments not included in the scope of GASB Statement No. 53.

- Normal purchases and normal sales contracts if both of the following are met:
  - It is *probable* the government will take or make delivery of the commodity specified.
  - The commodity delivered is *expected to be used* in the government's normal operations.
- Insurance contracts accounted for under GASB Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, as amended.
- Certain financial guarantee contracts that meet the definition of a derivative instrument and that are not entered into as an investment derivative instrument primarily for the purpose of obtaining income or profit.
- Certain contracts that are not exchange-traded and that have a reference rate based on any of the following:
  - Climatic, geological, or other physical variable (for example, temperature and rainfall).
  - Price or value of a nonfinancial asset that is not readily convertible to cash.
  - Specific volumes of sales or service revenues of one of the parties to the contract (for example, volumetric production payments associated with an oil or gas well).
- Loan commitments (for example, first-time home buyers for mortgage loans).

Derivative Instrument Risk

5.110 Investment derivative instruments may have the following risks that could give rise to financial loss:

- *Credit risk*. The risk that a counterparty to the investment derivative instrument will not fulfill its obligations.
- *Interest rate risk*. The risk that changes in interest rates will adversely affect the cash flows or fair value of an investment derivative instrument.
- *Foreign currency risk*. The risk that changes in exchange rates will adversely affect the cash flows or fair value of an investment derivative instrument.

5.111 Hedging derivative instruments may have the following risks:

- *Credit risk*. The risk that counterparty to the hedging derivative instrument will not fulfill its obligations.
- *Interest rate risk*. The risk that changes in interest rates will adversely affect the cash flows or fair value of a hedging derivative instrument.
- *Basis risk.* The risk that arises when variable rates or prices of a hedging derivative instrument and a hedged item are based on different reference rates.

- *Termination risk.* The risk that a hedging derivative instrument's unscheduled end will affect a government's asset and liability strategy or will present the government with potentially significant unscheduled termination payments to the counterparty.
- *Rollover risk.* The risk that a hedging derivative instrument associated with a hedgeable item does not extend to the maturity of that hedgeable item. When the hedging derivative instrument terminates, the hedgeable item will no longer have the benefit of the hedging derivative instrument.
- *Market access risk.* The risk that a government will not be able to enter credit markets or that credit will become more costly.
- *Foreign currency risk*. The risk that changes in exchange rates will adversely affect the cash flows or fair value of a hedging derivative instrument will become more costly.

Compliance Requirements and Derivative Instrument Policies

5.112 Governments usually have extensive legal and contractual provisions relating to their derivative instruments that often differ for different funds and different objectives (like risk management versus investment). Those requirements may involve, for example, the circumstances in which the government may enter into a derivative arrangement, the types of derivative instruments a government may use (see paragraph 5.100), and the counterparties with which it may conduct business. Governments often document their derivative instrument policies in writing and have them approved by the governing board.[7] Those policies often establish stated or implied objectives with respect to hedging derivative instruments and derivative instruments that are investments. To help management adhere to those objectives, derivative instrument policies often list, among other things

- the types and terms of derivative instruments that are permitted or prohibited.
- required characteristics of counterparties to the arrangement (such as credit rating, capitalization, and so on) methods by which fair value will be determined.
- how hedges will be evaluated for effectiveness and frequency.
- minimum or maximum length or both of the derivative instrument.
- circumstances in which the government will pursue early termination of a derivative arrangement.

5.113 Some funds, such as pension trust and permanent funds, may have a higher risk tolerance than the general fund where liquidity requirements require a lower risk tolerance. Such other funds may therefore be authorized to enter into derivative arrangements with more risk such as counterparties with a lower credit rating or a longer term of the derivative arrangement to maturity. As with cash, investments, and investment-related transactions, for funds such as pension trust and permanent funds, compliance requirements and derivative

[7] GASB Statement No. 53 does not require a government to establish derivative instrument policies; however, governments should disclose derivative instrument policies related to the risks that GASB Statement No. 53, as amended, requires be disclosed.

instrument policies may establish a "prudent person rule" rather than a "legal list" of permitted or prohibited types and terms of derivative instruments.

Accounting and Financial Reporting Considerations—Derivative Instruments

5.114 GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, as amended, requires that governments report derivative instruments (other than synthetic guaranteed investment contracts [SGICs] that are fully benefit-responsive)[8] at fair value in their economic resources measurement focus financial statements (such as the government-wide and proprietary fund statements of net position and the statement of fiduciary net position) as either assets or liabilities. Additionally, GASB Statement No. 53 requires changes in the fair value of derivative instruments that are used for investment purposes, or that are reported as investment derivative instruments because they do not meet the criteria of a hedging derivative instrument, to be reported in the investment revenue classification on the flow of resources statement (such as the government-wide statement of activities; the statement of revenues, expenses, and changes in fund net position; and the statement of changes in fiduciary net position). Changes in the fair value of derivative instruments classified as hedging derivative instruments are reported as either deferred inflows of resources or deferred outflows of resources in the statement of net position (the government-wide and proprietary fund statements of net position and the statement of fiduciary net position). See paragraphs 5.105–.106 for a further discussion of hedge accounting.

5.115 Hedge accounting should be applied beginning in the period that a hedging derivative instrument is established and until a termination event occurs (see paragraphs 5.117–.119). Potential hedging derivative instruments should be evaluated for effectiveness as of the end of each reporting period. For hedgeable items that are existing, or expected, financial instruments and for hedgeable items that are existing, or expected, commodity transactions, GASB Statement No. 53, as amended, identifies the following methods that should be used to evaluate these potential hedging derivative instruments for effectiveness:

- Consistent critical terms
- Quantitative methods including synthetic instrument method, dollar-offset method, and regression analysis method[9]

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[8] Fully benefit-responsive synthetic guaranteed investment contracts (SGICs)—the combination of the underlying investments and the wrap contract (that is, contract in which issuer provides assurance that adjustments to the interest crediting rate of a SGIC will not result in a future interest crediting rate less than zero)—are reported at contract value. Paragraph 67 of GASB Statement No. 53 delineates the criteria for a fully benefit-responsive SGIC.

[9] Other quantitative methods may be used to evaluate effectiveness if they meet all of the following criteria:

a. Through identification and analysis of critical terms, the method demonstrates that the changes in cash flows or fair values of the potential hedging derivative instrument substantially offset the changes in cash flows or fair values of the hedgeable item.

b. Replicable evaluations of effectiveness are generated that are sufficiently complete and documented such that different evaluators using the same method and assumptions would reach substantially similar results.

c. Substantive characteristics of the hedgeable item and the potential hedging derivative instrument that could affect their cash flows or fair values are considered.

Although the acceptable methodologies to determine the effectiveness of potential hedging derivative instruments are the same for financial instruments and commodity transactions, their application is different for the various transactions. Appendix B10-2 of the IG 2015-1 provides nonauthoritative illustrations of common derivative instrument applications. Questions 10.20.1–10.39.1 of the IG 2015-1 discuss the various methodologies that may be used to determine the effectiveness of potential hedging derivative instruments.

5.116 Hedge accounting should cease to be applied upon the occurrence of one of the following termination events:[10]

a. The hedging derivative instrument is no longer effective.

b. The likelihood that a hedged expected transaction will occur is no longer probable.

c. The hedged asset or liability, such as a hedged bond, is sold or retired but not reported as a current refunding or advanced refunding resulting in a defeasance of debt.

d. The hedging derivative instrument is terminated unless an effective hedging relationship continues. An effective hedging relationship continues when all of the following criteria are met:

  i. Collectibility of swap payments is considered to be probable.

  ii. The swap counterparty of the interest rate swap or commodity swap, or the swap counterparty's credit support provider, is replaced with an assignment or in-substance assignment.

  iii. The government enters into the assignment or in-substance assignment in response to the swap counterparty, or the swap counterparty's credit support provider, either committing or experiencing an act of default or a termination event as both are described in the swap agreement.

  iv. The swap is assigned in one of the following ways:

    (1) The swap is assigned or amended to replace the original swap counterparty or the swap counterparty's credit support provider, but all of the other terms of the swap agreement remain unchanged.

    (2) There is an *in-substance assignment*. That is defined as follows:

      (a) The original swap agreement is ended, and the replacement swap agreement is entered into on the same date.

      (b) The terms that affect changes in fair values and cash flows in the original and replacement swap agreements are identical. These terms include, but are not limited to, notional amounts; terms to

[10] GASB IG 2015-1 questions 10.15.1–10.15.9 discuss termination of hedge accounting.

maturity; variable payment terms; reference rates; time intervals; fixed-rate payments; frequencies of rate resets; payment dates; and options, such as floors and caps.

(c) Any difference between the original swap agreement's exit price and the replacement swap's entry price is attributable to the original swap agreement's exit price being based on a computation specifically permitted under the original swap agreement. Exit price represents the payment made or received as a result of terminating the original swap. Entry price represents the payment made or received as a result of entering into a replacement swap.

e. A current refunding or advanced refunding resulting in the defeasance of the hedged debt is executed.

f. The hedged expected transaction occurs. If a termination event occurs, the balance in the deferral account should be reported on the flow of resources statement within the investment revenue classification.

5.117 If the termination event is the current refunding or advanced refunding resulting in the defeasance of the hedged debt (paragraph 5.116*e*), the balance of the deferral account should be included in the net carrying amount of the old debt for purposes of calculating the difference between that amount and the reacquisition price of the old debt. This approach should be applied regardless of whether the hedging derivative instrument is terminated. The calculation of the difference between the cash flows required to service the old debt and the cash flows required to service the new debt and complete the refunding and the economic gain or loss resulting from the transaction should include the effects of a hedging derivative instrument.

5.118 If the termination event is the occurrence of the hedged expected transaction (paragraph 5.116*f*), the disposition of the deferral balance depends on whether the hedged expected transaction results in a financial instrument or a commodity. If the expected transaction results in a financial instrument and the government is re-exposed to the hedged risk, the balance of the deferral account should be recognized on the flow of resources statement within the investment revenue classification. On the other hand, if the government is not re-exposed to the hedged risk, the balance in the deferral account should be reported on the flow of resources statement consistent with the hedged item. The decision regarding whether a termination event re-exposes a government to a hedged risk should be based on specific facts and circumstances. If the expected transaction results in a commodity, the balance of the deferral account should be removed by reporting the balance as an adjustment to the actual transaction.

5.119 GASB Statement No. 53, as amended, requires numerous note disclosures about derivative instruments. The following list describes the required disclosures in summary form which may be presented in columnar display, narrative form, or a combination of both. Paragraphs 69–78 of GASB Statement

No. 53 include the more detailed disclosure requirements, and the IG 2015-1 questions 10.46.1–10.46.10 also discuss disclosures in the notes to the financial statements:

- *Summary information.* Related to derivative instrument activity during the period and balances at the end of the reporting period organized by governmental and business-type activities and fiduciary funds, divided into hedging derivative (separate disclosure of fair value and cash flow hedges) and investment derivative instruments, and aggregated by type of derivative instrument (like receive-fixed swaps, pay-fixed swaps, swaptions, rate caps, basis swaps, and futures contracts). Summary information should include
  - — notional amount.
  - — changes in fair value during the period and classification in the financial statements where changes in fair value are reported.
  - — fair values at the end of the reporting period and classification in the financial statements where those fair values are reported.
  - — fair values of derivative instruments reclassified from a hedging derivative to an investment derivative instrument including the deferral amount reported within investment revenue due to the reclassification.
  - — fair value disclosures required by paragraphs 80–81 of GASB Statement No. 72.
- *For all hedging derivative instruments.* Objectives for entering into those instruments, terms, credit risk, interest rate risk, basis risk, termination risk, rollover risk, market-access risk, foreign currency risk, hedged debt, other quantitative methods of evaluating effectiveness.
- *For investment derivative instruments.* Exposure to risks that could give rise to financial loss including credit risk, interest rate risk, and foreign currency risk (disclosed consistent with disclosures required in GASB Statement No. 40). These disclosures are required only for investment derivative instruments that are reported as of the end of the reporting period. Investment derivative instruments include derivative instruments that do not meet the criteria of a hedging derivative instrument.
- *Contingent features.* For derivative instruments held at the end of the reporting period disclosures should include existence and nature of contingent features and circumstances in which they could be triggered, aggregate fair value of derivative instruments containing those features, aggregate fair value of asset that would be required to be posted as collateral or transferred in accordance with provisions related to triggering contingent liabilities, and the amount (if any) posted as collateral as of the end of the reporting period.
- *Hybrid instruments.* Disclosures of the companion instrument should be consistent with disclosures required of similar transactions.

- *SGICs that are fully benefit-responsive.* A description of the nature of the SGIC and the SGIC's fair value including the fair value of (*a*) the wrap contract and (*b*) the corresponding underlying investments.

5.120 Because of the highly technical nature of fair value calculations, the government may use the services of an outside specialist or pricing service to provide valuation services related to fair value measurements and disclosures. When a specialist or pricing service is used, management of the government should possess a level of knowledge sufficient to

- determine the appropriateness of the methodologies used by the specialist in light of GAAP and existing facts and circumstances;
- review the results of the specialist for reasonableness;
- ascertain the adequacy of any related disclosures provided by the specialist; and
- prepare the related disclosures required by GAAP if not provided by the specialist.

Auditing Considerations—Derivative Instruments

5.121 AU-C section 501 address specific considerations by the auditor in obtaining sufficient appropriate audit evidence, in accordance with other relevant AU-C sections, regarding certain aspects of investments in securities and derivatives.[11] Among other things, AU-C section 501

- indicates that an auditor may need special skill or knowledge to plan and perform auditing procedures for certain assertions about derivative instruments and securities, such as the ability to identify a derivative that is embedded in a contract or agreement;
- presents examples of factors that affect inherent and control risk for assertions about derivative instruments and securities; and
- provides examples of audit procedures for derivative instruments, securities, and hedging activities.

5.122 AU-C section 402, *Audit Considerations Relating to an Entity Using a Service Organization* (AICPA, *Professional Standards*), provides requirements and guidance on the factors auditors (referred to as *user auditors*) should consider when auditing financial statements of an entity that uses a service organization to process certain transactions. Examples where this may apply with regard to derivatives include engaging a service organization to (*a*) conduct transactions related to its derivative instruments, (*b*) determine the fair value of its derivative instruments, (*c*) determine hedge effectiveness, or (*d*) maintain derivative instrument accounting records. As an aside, the AICPA Guide *Service Organizations—Reporting on Controls at a Service Organization Relevant to User Entities' Internal Control Over Financial Reporting* and AT-C section 320, *Reporting on an Examination of Controls at a Service Organization Relevant to User Entities' Internal Control Over Financial Reporting*

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[11] The AICPA Audit Guide *Special Considerations in Auditing Financial Instruments* provides additional and more detailed guidance to auditors related to planning and performing auditing procedures for assertions about derivative financial instruments, hedging activities, and investments in securities. See paragraph 5.131 of this guide for additional information related to the accounting guidance in the AICPA Audit Guide *Special Considerations in Auditing Financial Instruments* and the limited relevance of that guidance to state and local governments.

(AICPA, *Professional Standards*), provide guidance for independent auditors (service auditors) who issue reports on processing of transactions by service organizations for use by other auditors. Further, governments may use specialists, including their investment service organizations, to determine fair value measurements for investments and provide specialized reports for deposit and investment risk disclosures. Similarly, auditors may use specialists to evaluate those measurements and disclosures. AU-C section 620 provides requirements and guidance when using the work of an auditor's specialist.

5.123 Chapter 4, "General Auditing Considerations," discusses the requirements in AU-C section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* (AICPA, *Professional Standards*), which are designed to assist the auditor in identifying material misstatement of the financial statements due to noncompliance with laws and regulations. Many compliance requirements that affect a government's derivative instruments may not have a direct and material effect on the determination of financial statement amounts. However, the auditor may become aware of noncompliance that may not have a direct effect but could nevertheless have a material effect on a government's financial statements as in these examples: the use of unauthorized counterparties, the use of unauthorized derivative instrument types or terms, or the lack of separate accounts for individual funds when required. If the auditor identifies noncompliance that has a material effect on the financial statements, the auditor should consider whether it has been adequately reflected in the financial statements. If the noncompliance has not been adequately reflected the auditor should, as provided in AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report* (AICPA, *Professional Standards*), express a qualified or adverse opinion on the financial statements. The auditor also should communicate the noncompliance to those charged with governance of the entity as provided in AU-C section 250. The auditor also may be required to communicate instances of noncompliance to appropriate oversight bodies and funding agencies.

5.124 The audit objectives for derivative instrument transactions of each opinion unit, categorized by financial statement assertion, are as follows:

Assertions about classes of transactions and events for the period under audit:

- *Occurrence*
  - — Reported investment income related to (*a*) changes in the fair value of investment derivative instruments and embedded derivative instruments; (*b*) changes in the fair values of derivative instruments and embedded derivative instruments that do not meet the criteria of a hedging derivative instrument; and (*c*) reversals of deferred inflows of resources and deferred outflows of resources from hedging derivative instruments and embedded hedging derivative instruments that no longer meet the criteria of a hedging derivative instrument represent amounts that are related to the period and are applicable to the governmental entity.
  - — Cash flows related to derivative instruments and embedded derivative instruments, if any, represent amounts that are related to the period and to the governmental entity.

- *Completeness*
  - — All investment income related to (*a*) changes in the fair value of investment derivative instruments and embedded derivative instruments; (*b*) changes in the fair values of derivative instruments and embedded derivative instruments that do not meet the criteria of a hedging derivative instrument; and (*c*) reversals of deferred inflows of resources and deferred outflows of resources from hedging derivative instruments and embedded hedging derivative instruments that no longer meet the criteria of a hedging derivative instrument is reported.
  - — Reported investment income does not include changes in the fair value of hedging derivative instruments or embedded hedging derivative instruments.
  - — Economic gains or losses on debt refundings include the effect of any hedging derivative instrument related to the refunded debt.
  - — All cash flows related to derivative instruments and embedded derivative instruments, if any, are reported.
- *Accuracy*
  - — The amount included in investment income related to (*a*) changes in the fair value of investment derivative instruments and embedded derivative instruments; (*b*) changes in the fair values of derivative instruments and embedded derivative instruments that do not meet the criteria of a hedging derivative instrument; and (*c*) reversals of deferred inflows of resources and deferred outflows of resources from hedging derivative instruments and embedded hedging derivative instruments that no longer meet the criteria of a hedging derivative instrument have been accurately calculated and reported.
  - — The amount of any deferred inflows of resources and deferred outflows of resources related to refunded debt and included in the related economic gain or loss is accurately calculated and reported.
  - — All cash flows related to derivative instruments and embedded derivative instruments, if any, are accurately calculated and reported.
- *Cutoff*
  - — The amount included in investment income related to (*a*) changes in the fair value of investment derivative instruments and embedded derivative instruments; (*b*) changes in fair values of derivative instruments and embedded derivative instruments that do not meet the criteria of a hedging derivative instrument; and (*c*) reversals of deferred inflows of resources and deferred outflows of resources from hedging derivative instruments and embedded hedging derivative instruments that no longer meet

the criteria of a hedging derivative instrument have been recorded in the correct accounting period.

- — The amount of any deferred inflows of resources and deferred outflows of resources related to refunded debt and included in the related economic gain or loss is calculated as of the refunding transaction date.
- — All cash flows related to derivative instruments and embedded derivative instruments, if any, have been reported in the proper period.

- *Classification*
  - — Amounts related to (*a*) changes in the fair value of investment derivative instruments and embedded derivative instruments; (*b*) changes in the fair values of derivative instruments and embedded derivative instruments that do not meet the criteria of a hedging derivative instrument; and (*c*) reversals of deferred inflows of resources and deferred outflows of resources from hedging derivative instruments and embedded hedging derivative instruments that no longer meet the criteria of a hedging derivative instrument have been properly reported as investment revenue.
  - — The amount of any deferred inflows of resources or deferred outflows and resources related to refunded debt has been properly included in the related economic gain or loss on the refunding transaction.
  - — All cash flows related to derivative instruments and embedded derivative instruments, if any, have been properly classified in the statement of cash flows.

Assertions about account balances at the period end:

- *Existence*
  - — Reported investment derivative instruments represent current valid investment or embedded investment derivative arrangements.
  - — Reported hedging derivative instruments represent current valid hedging or embedded hedging derivative arrangements.
  - — Reported deferred inflows of resources and deferred outflows of resources represent changes in hedging or hybrid hedging derivative instruments for current valid hedging derivative arrangements
- *Rights and obligations*
  - — The financial statements properly reflect conditions and agreements that affect the government's rights and obligations concerning investment derivative instruments.
  - — The financial statements properly reflect conditions and agreements that affect the government's rights and obligations concerning hedging derivative instruments.

- The financial statements properly reflect conditions and agreements that affect the government's rights and obligations concerning embedded derivative instruments.

- *Completeness*
  - The financial statements report all balances of investment or hybrid investment derivative instruments.
  - The financial statements report all balances of hedging derivative instruments.
  - The financial statements report all balances of embedded derivative instruments that are investment or hedging derivative instruments.
  - The financial statements do not report normal purchases and sales, certain insurance and financial guarantee contracts, or certain contracts that are nonexchange traded as investment or hedging derivative instruments.
  - The companion instrument portion of any hybrid instrument is not reported as an investment or hedging derivative instrument.
  - Deferred inflows of resources and deferred outflows of resources are reported for all hedging derivative instruments.
  - Deferred inflows of resources and deferred outflows of resources are not reported for derivative instruments that do not meet the criteria of a hedging derivative instrument.

- *Valuation and allocation*
  - The fair values of reported investment, hedging, and embedded derivative instruments have been determined in accordance with GAAP (that is, market price when available and discounted forecasted future cash flows when market price not available).
  - Hedge effectiveness has been determined using methods allowable under GAAP (for example, consistent critical terms or quantitative methods).
  - Deferred inflows of resources and deferred outflows of resources have been determined for hedging derivative instruments based on fair values determined in accordance with GAAP (for example, market price when available and discounted forecasted future cash flows when market price not available).

Assertions about presentation and disclosure:

- *Occurrence and rights and obligations*
  - All disclosed events and transactions concerning investment, hedging, and embedded derivative instruments and related cash flows have occurred and pertain to the government.

— Conditions and agreements that affect the government's rights and obligations concerning investment, hedging, and embedded derivative instruments have been properly reported and disclosed.

- *Completeness*

  — All material investment, hedging, and embedded derivative instruments have been disclosed on the appropriate statement of net position as either assets or liabilities or deferred outflows of resources or deferred inflows of resources.

  — All material investment, hedging, and embedded derivative instrument transactions have been disclosed in the flow of resources statements (government-wide statement of activities; proprietary fund statement of revenues, expenses, and changes in net position; and changes in fiduciary net position).

  — All material cash flows related to investment, hedging, and embedded derivative instrument transactions have been included in the statement of cash flows.

  — All note disclosures required in paragraphs 68–79 of GASB Statement No. 53, as amended, pertaining to investment, hedging, and embedded derivative instruments are included.

  — All note disclosures required in paragraphs 80–81 of GASB Statement No. 72 pertaining to investment derivative instruments are included.

- *Classification and understandability*

  — Amounts related to (*a*) changes in the fair value of investment derivative instruments and embedded derivative instruments, (*b*) changes in the fair values of derivative instruments and embedded derivative instruments that do not meet the criteria of a hedging derivative instrument, and (*c*) reversals of deferred inflows of resources and deferred outflows of resources from hedging derivative instruments and embedded hedging derivative instruments that no longer meet the criteria of a hedging derivative instrument have been properly classified as investment revenue.

  — Investment, hedging, and embedded derivative transactions have been properly classified in the flow of resources statements (government-wide statement of activities; proprietary fund statement of revenues, expenses, and changes in net position; and changes in fiduciary fund net position).

  — Deferred inflows of resources and deferred outflows of resources related to hedging derivative instruments have been properly classified in the appropriate statement of net position.

- Cash flows related to investment, hedging, and embedded derivative instruments are appropriately classified.
- Amounts presented in the aggregate in the financial statements related to investment, hedging, or embedded derivative instruments are appropriately aggregated to enhance understandability.
- Note disclosures are clearly expressed individually or in the aggregate for similar derivative instrument types based on the type and nature of the derivative instrument, the hedged item, or the reference rate.

- *Accuracy and valuation*
  - Investment, hedging, and embedded derivative instruments and transactions are accurately displayed and disclosed in accordance with the provisions of GASB Statement No. 53, as amended.
  - Cash flows related to investment, hedging, and embedded derivative instruments are displayed and disclosed fairly and at appropriate amounts in accordance with GAAP.

5.125 When obtaining an understanding of controls that are relevant to the audit, the auditor should evaluate the design of the controls and determine whether they have been implemented by performing procedures in addition to the inquiry of the government's personnel. Obtaining this understanding include a government's internal control over derivative instruments. In addition to standard internal control features, features that are unique or significant for a government with derivative instruments may include the following:

- The integration of the entity's derivative instrument program with its cash-flow needs.
- Procedures to ensure that written agreements with counterparties, service organizations, or specialists address all important factors and that they are adhered to.
- Initial and periodic review of all derivative instrument transactions to determine
  - proper recognition as derivative instruments, and
  - proper classification of the derivative instrument as an investment or potential hedging derivative instrument.
- Derivative instrument transactions and amounts are recorded, reported, and disclosed in accordance with GAAP.
- Compliance with adopted policies and procedures related to derivative instruments.

5.126 Audit procedures related to derivative instruments are normally specific to the type of derivative instrument (for example, investment, hedging, or embedded derivative instrument), the extent to which the types of derivative transactions are used, and the related audit risk. The nature, timing, and extent of the audit procedures[12] to test derivative instrument recognition, fair

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[12] In developing these procedures the auditor generally considers differences in the government's financial statement date and the date(s) of the fair value measurements and hedge effectiveness evaluations as well as the need for additional procedures to obtain sufficient and appropriate evidence related to the measurement and presentation of a government's derivative instruments.

value measurements, hedge effectiveness evaluations, and disclosures related to derivative instruments will be based, in part, on the auditor's understanding of

- the government's policies related to and objectives for using derivative instruments.
- the government's internal control over initial and on-going recognition of derivative instruments including the staff responsible and their expertise in derivative instruments.
- the party responsible (internal staff/specialist or external specialist) for measuring fair value, methods used to determine fair value (for example, quoted market price or discounted forecasted future cash flows), and when the government measures fair value (such as interim or year-end).
- the party responsible (internal staff or specialist, or external specialist) for evaluating potential hedging derivative instruments for effectiveness, method used to determine hedge effectiveness (for example, consistent critical terms or quantitative methods), and when the government evaluates potential hedging derivative instruments for effectiveness (such as interim or year-end).
- assessment of the risk of material misstatement.

5.127 Because derivative instruments are reported at fair value and changes in fair value for hedging derivative instruments that are effective are reported as deferred outflows or deferred inflows, the risk of material misstatement may be high. Therefore, the auditor may need to perform additional risk assessment procedures (see paragraph 5.128) or further audit procedures (see paragraphs 5.129–.130) with respect to the professional requirements under AU-C section 540 for auditing fair value estimates. The extent of any additional risk assessment or further audit procedures is dependent on the related assessed risk of material misstatement in the financial statements.

5.128 Risk assessment procedures the auditor may want to consider include the following:

- Review state and local laws and regulations, debt issuance documents, derivative instrument agreements, and other similar documents for compliance requirements that could have a direct and material effect on the determination of financial statement amounts and determining whether those provisions are appropriately considered in the entity's written policy related to derivative instruments.
- Read minutes of the meetings of the governing body and any audit/finance committee noting discussions of and actions related to derivative policies, procedures, or agreements.
- Read policies and procedures relevant to derivative instruments and determine if such policies and procedures are in accordance with GAAP and appropriate and reasonable in the circumstances.
- Read derivative instrument agreements.
- Consider evidence from other audit areas (debt, leases, investments, insurance, cash disbursements and receipts tests of details).

- Obtain an understanding of internal control over financial accounting and reporting of derivatives instruments including internal control over determining if derivative instruments are included in or excluded from the requirements of GASB Statement No. 53, as amended.
- Determine if internal control over derivative instruments and derivative-like instruments is effective and if control testing is needed or efficient or both.
- Review the government's compliance at year-end and during the year with compliance requirements that could have a direct and material effect on the determination of financial statements amounts.
- Determine inherent risk.

5.129 After completing risk assessment procedures related to derivative instruments, the auditor may want to consider the following additional audit procedures for derivative instruments:

- Determine control risk.[13]
- Identify relevant assertions for account balances, classes of transactions, and presentation and disclosure and assess the related risk of material misstatement.
- Establish materiality, performance materiality, and tolerable misstatement for individual account balances, classes of transactions, and disclosures related to derivative instruments.
- Perform substantive analytical procedures if they would be appropriate or efficient or both.
- Obtain appropriate audit evidence related to recorded derivative transactions as well as evidence that there are no unrecorded or unreported derivative transactions for the reporting period.

5.130 The auditor might consider the following procedures related to presentation and disclosure assertions:

- Determine if all disclosures required by GASB Statement No. 53, as amended, and GASB Statement No. 72 have been made as applicable for the types of reported derivative instruments.
- Review subsequent events for effects on recorded amounts (for example, fair value and hedge effectiveness assumptions, probability associated with expected transactions of normal purchases and sales) and note disclosures.
- Obtain appropriate specific representations from management related to derivative instruments.

5.131 The AICPA Audit Guide *Special Considerations in Auditing Financial Instruments* includes guidance on fair value measurements and related internal controls as well as a discussion of GAAP related to measuring and reporting derivative instruments, securities, and hedging activities for nongovernmental entities. Users of this guide should be aware that although portions of that guide are helpful, accounting, reporting, and auditing guidance

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[13] Any deficiencies in internal control related to derivative instruments that are identified through risk assessment or further audit procedures should be evaluated for severity with any significant deficiencies and material weaknesses communicated in writing to those charged with governance.

is related to derivative instrument, hedging, and securities transactions from a private-sector perspective which is not consistent with the requirements of GASB Statement No. 53, as amended. Specifically, the accounting and financial reporting guidance is that established by the FASB and therefore not applicable to preparing and auditing government financial statements.

Chapter 6

Revenues and Receivables

Introduction

6.01 Revenue[1] and receivable transactions are closely related and represent inflows of resources[2] to the government that are applicable to the reporting period. Because revenue and receivable transactions are closely related, many audit procedures satisfy the audit objectives of both types of accounts at the same time. That is, evidence that supports assertions about revenues also generally supports assertions about receivables. This chapter discusses accounting, financial reporting, and auditing considerations relating to various transactions and events that result in revenues and receivables.

Update 6-1 ***Deferred Outflows of Resources and Deferred Inflows of Resources***

GASB Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*, requires that changes in the net or total postemployment benefits other than pensions (OPEB) liability, as applicable, that have not been included in OPEB expense are required to be reported as deferred outflows of resources or deferred inflows of resources related to OPEB. Additionally, for circumstances in which OPEB is provided through an OPEB plan that is administered through a trust that meets the specified criteria, employer OPEB contributions made subsequent to the measurement date of the net OPEB liability and before the end of the reporting period are required to be reported as deferred outflows of resources. For circumstances in which OPEB is provided through an OPEB plan that is not administered through a trust that meets the specified criteria, amounts paid by the employer for OPEB as the benefits come due subsequent to the measurement date of the total OPEB liability and before the end of the reporting period, and amounts for OPEB administrative expenses incurred subsequent to the measurement date of the total OPEB liability and before the end of the reporting period are required to be reported as deferred outflows of resources.

The statement was issued in June 2015 and is effective for fiscal years beginning after June 15, 2017. Earlier application is encouraged.

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[1] In general, this chapter does not discuss interfund transfers, loans, or reimbursements; see chapter 9, "Interfund, Internal, and Intra-Entity Activity and Balances," for those items. The term *revenue* is used in a generic manner throughout much of this chapter to refer to the resource inflows from other than interfund transfers that are reported in a government's activity statements. GASB standards require different classifications of those reported resource inflows in the various financial statements, as discussed later in this chapter.

[2] GASB Concepts Statement No. 4, *Elements of Financial Statements*, defines an inflow of resources as the acquisition of net assets by the government that is applicable to the reporting period. When net assets are obtained by a government, the acquisition of net assets occurs even if those net assets are directly consumed when acquired. Acquisitions of net assets result in either (*a*) an increase in assets in excess of any related increase in liabilities or (*b*) a decrease in liabilities in excess of any related decrease in assets. Sale of taxable merchandise by a retailer is an example of the acquisition of net assets by a government.

Those implementing GASB Statement No. 75 may refer to chapter 14, "Defined Benefit Postemployment Benefits Other Than Pensions (Plan & Employer Considerations)," for guidance related to accounting and reporting for OPEB plans under the new statement.

GASB Statement No. 83, *Certain Asset Retirement Obligations*, requires a government that has legal obligations to perform future asset retirement activities related to its tangible capital assets to recognize a liability and a corresponding deferred outflow of resources.

GASB Statement No. 83 was issued in November 2016 and is effective for reporting periods beginning after June 15, 2018.

The full text of both statements are available on GASB's website at www.gasb.org.

6.02 Deferred outflows of resources and deferred inflows of resources arise when governments enter into transactions that have been identified by GASB that result in the acquisition or consumption of net assets in one period that are applicable to future periods. According to GASB Concepts Statement No. 4, *Elements of Financial Statements*, recognition of deferred outflows of resources and deferred inflows of resources should be limited to those instances identified by GASB in authoritative pronouncements. GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*; GASB Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements*; GASB Statement No. 65, *Items Previously Reported as Assets and Liabilities*; GASB Statement No. 68, *Accounting and Financial Reporting for Pensions—an amendment of GASB Statement No. 27*, as amended; GASB Statement No. 69, *Government Combinations and Disposals of Government Operations*; GASB Statement No. 73, *Accounting and Financial Reporting for Pensions and Related Assets That Are Not within the Scope of GASB Statement 68, and Amendments to Certain Provisions of GASB Statements 67 and 68*; and GASB Statement No. 81, *Irrevocable Split-Interest Agreements*, contain those requirements and are discussed in chapter 2, "Financial Reporting."

Nature of Transactions

6.03 In government, there often are numerous locations for billing, accounting, and cash collection—for example, tax collection departments for income, sales, or property taxes; billing departments for services rendered; courts for fines or judgments; and recreational facilities and parking garages for user fees. Because billing, accounting, and collection functions may not be centralized, an entity's need to establish multiple internal control systems related to those functions may increase control risk over revenues and receivables. Also, cash collections of small, occasional receipts, such as for permits and licenses, may increase inherent or control risk or both.[3] Sometimes a government's revenues are collected by another entity, either another government (such as a county tax collector or a tax bureau) or a nongovernmental entity (such as a financial institution with which the government contracts for *lock-box* services).

6.04 General-purpose governments typically have large amounts of revenues and receivables that result from nonexchange transactions, particularly

[3] Even small amounts of cash collections may be of concern to an auditor because of the entity's fiduciary responsibilities for the moneys and the adverse publicity that can result from a loss.

in governmental funds and activities. As defined in paragraph 1 of GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, in a nonexchange transaction, a government gives (or receives) value without directly receiving (or giving) equal value in exchange. Examples of nonexchange revenues are those that arise from income, sales, and property taxes; fines and certain fees; certain intergovernmental grants, entitlements, and other financial assistance; and private donations.

6.05 Governments also have revenues and receivables that result from exchange and exchange-like transactions, particularly in proprietary funds and business-type activities. As defined in GASB Statement No. 33 paragraph 1, exchange and exchange-like transactions are those in which each party receives and gives up essentially equal values.[4] Examples of exchange and exchange-like revenues are those that arise from investment income; user fees; and sales and leases of capital assets.

6.06 Activities between the funds of a primary government and between a primary government and its component units also may generate revenues and receivables. For example, the general fund or internal service funds may provide services to other funds—for example, communications (telephone and mail), data processing, printing and duplication, motor pool and maintenance operations, central supplies, building occupancy and maintenance, and risk retention. Chapter 9, "Interfund, Internal, and Intra-Entity Activity and Balances," discusses accounting, financial reporting and auditing considerations for reporting those activities in the financial reporting entity's financial statements. However, the measurement and recognition standards for some of the transactions and other events discussed in or referenced from this chapter apply to those activities, subject to the provisions concerning interfund, internal, and intra-entity activity and balances of GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, as amended. Although the provisions of GASB Statement No. 33, as amended by GASB Statement No. 36, *Recipient Reporting for Certain Shared Nonexchange Revenues—an amendment of GASB Statement No. 33*, which are discussed in this chapter, do not apply to activities between the funds of a primary government, they do apply to the recognition and measurement of transactions between the primary government and its discretely presented component units. However, the provisions of GASB Statement No. 34, as amended, for interfund, internal, and intra-entity activity and balances affect how nonexchange transactions between the primary government and its component units are reported when component units are included with the primary government in the reporting entity's financial statements.[5]

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[4] Footnote 1 of GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, states that "In contrast to a 'pure' exchange transaction, an exchange-like transaction is one in which the values exchanged, though related, may not be quite equal or in which the direct benefits may not be exclusively for the parties to the transaction. Nevertheless, the exchange characteristics of the transaction are strong enough to justify treating the transaction as an exchange for accounting recognition."

[5] Paragraph 61 of GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, as amended, states that resource flows between the primary government and blended component units should be reclassified as internal activity in the financial statements of the reporting entity. Resource flows (except those that affect the statement of position only, such as loans, repayments, and deferred inflows of resources and deferred outflows of resources resulting from intra-entity transactions) between a primary government and its discretely presented component units should be reported as if they were external transactions. However, amounts payable and receivable between the primary government and its discretely presented component units or between those components should be reported on a separate line.

6.07 The revenue transactions of governments, particularly nonexchange transactions, often are subject to various compliance requirements, such as the following:

- Many intergovernmental grants and entitlements and private donations have eligibility requirements, purpose restrictions, and other requirements that the government should meet to comply with the terms of the grant or gift.
- Legal provisions often establish various limits on the government's taxation of its citizens. Property tax levies often are subject to a budgetary process that requires public notification and hearings and the passage of appropriations that limit the government's spending authority.
- Sometimes, governments are required to obtain voter approval to issue debt and levy property taxes to repay that debt.
- Specific voter approval often is required before a local government can impose or increase its sales or income tax rates, and those approvals often are subject to purpose restrictions on the use of the incremental revenues.
- Some governments have legal provisions that limit their revenues or their revenue growth, including limits on specific types of taxes, such as millage rate maximums on property taxes. Exceeding those limits may trigger a legal provision for tax refunds.
- Special assessments collected from a particular group of property owners should be used to finance capital improvements or services to those property owners.
- Many governments are permitted to seize or sell property for nonpayment of taxes, but there are legal provisions relating to the due process procedures they should follow to do so.

Although a government should be concerned with all compliance requirements, generally accepted auditing standards (GAAS) focus the auditor's concern on compliance requirements that could have a direct and material effect on the determination of financial statement amounts. (See further discussion of the auditor's responsibility in that regard in chapter 4, "General Auditing Considerations.")

6.08 Like other entities, governments have revenue collectibility concerns. In government, legal provisions often are designed to improve the collectibility of certain revenues, particularly tax revenues. For example, real property taxes often are deemed to be fully collectible because of legal provisions that permit the government to place a delinquent-tax lien against the property. Further, some governments that levy income taxes have legal provisions that allow them to apply overpayments that otherwise would be refunded to taxpayers against unpaid receivables for the same type of taxes, other types of taxes, or other amounts, such as utility service charges. However, for those legal provisions to be effective in reducing uncollectible receivables, the government has to enforce its legal rights. For example, a government that does not file liens against properties with delinquent tax payments generally would be unable to seize or sell that property to collect the delinquent revenue.

6.09 Amounts resulting from revenue transactions are classified in governmental financial statements in various ways. In the government-wide statement of activities, such amounts are classified as program revenues, general revenues, contributions to term and permanent endowments, contributions to permanent fund principal, special items, and extraordinary items. The governmental and proprietary fund financial statements report revenues by fund and major source and distinguish special items and extraordinary items from other revenues. Also, governmental funds distinguish revenues from other financing sources. Proprietary funds separately distinguish operating revenues and nonoperating revenues from capital contributions and additions to term and permanent endowments. The fiduciary fund statement of changes in fiduciary net position classifies transactions as *additions* rather than as *revenues*. In governmental financial statements, no resource inflows are reported as direct changes in fund balance or net position. See the detailed discussions of the classification of resource inflows in a government's financial statements in paragraphs 6.69–.85.

Accounting and Financial Reporting Considerations

6.10 This section on accounting and financial reporting considerations is structured to discuss the following:

- General recognition standards
- Recognition standards for (*a*) nonexchange transactions, (*b*) exchange transactions, (*c*) special assessments, and (*d*) amounts collected for individuals, other entities, or other funds
- Financial statement presentation for revenues and receivables
- Disclosures in the notes to the financial statements

Accounting

General Recognition Standards

6.11 Revenue recognition is affected by a financial statement's measurement focus and basis of accounting (MFBA). The government-wide statement of activities; the proprietary funds statement of revenues, expenses, and changes in fund net position; and the fiduciary funds statement of changes in fiduciary net position use the economic resources and accrual MFBA. Because of the economic resources measurement focus, revenue is reported for transactions and events involving not only the receipt of cash but also the receipt of capital assets (that is, capital asset donations). Because of the accrual basis of accounting, revenues and receivables resulting from exchange and exchange-like transactions are recognized in those financial statements when the exchange takes place;[6] revenues and receivables from nonexchange transactions are recognized in accordance with GASB Statement No. 33, as amended, as explained in detail later in this chapter.

6.12 The governmental funds statement of revenues, expenditures, and changes in fund balances uses the current financial resources and modified

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[6] For accrual-based recognition purposes, revenue from exchange and nonexchange transactions should be measurable. See GASB Statement No. 33 paragraph 11 and, in the nonauthoritative "Basis for Conclusions," paragraph 56.

accrual MFBA.[7] Because of the current financial resources measurement focus, governmental funds do not report revenues for donations of capital assets unless the donated assets will be held for sale. National Council on Governmental Accounting (NCGA) Statement 1, *Governmental Accounting and Financial Reporting Principles*, paragraph 62 establishes the standard for the modified-accrual recognition of revenues and other financial resource increments in governmental funds. It states that revenues should be recognized in the accounting period in which they become both measurable and available. *Measurable* refers to the ability to quantify in monetary terms the amount of the revenue and receivable. The term *available* generally means collectible within the current period or soon enough thereafter to be used to pay liabilities of the current period.

6.13 The only difference between accrual-basis recognition of financial resource inflows and modified accrual-basis recognition of financial resource inflows relates to availability.[8] GASB has not established specific standards that prescribe a time period for the availability criterion, except for property tax revenues as discussed in paragraph 6.31. However, many governments use the property tax standard by analogy and accrue other revenues in governmental funds based on the amount of the year-end receivables received in cash during a given number of days after year end. Many governments apply this *time period approach* consistently for all types of revenues and in all governmental funds and apply it consistently from year to year.

6.14 With the modified accrual basis of accounting, revenues resulting from exchange and exchange-like transactions are recognized when the exchange takes place, subject to the measurable and available criteria. Revenues from nonexchange transactions are recognized in accordance with GASB Statement No. 33, as amended, again, subject to the measurable and available criteria. Receivable balances in the governmental funds are reported using the accrual basis of accounting. When a receivable is recorded in governmental fund financial statements but revenue is not available, the government should report a deferred inflow of resources until such time as the revenue becomes available.

6.15 All receivables should be measured net of estimated uncollectible amounts. Charges for uncollectible revenues should reduce revenues, deferred inflows of resources, a liability account (for example, unearned revenue or advance), or the allowance for uncollectible revenues, as applicable. Charges for uncollectible revenues should not be reported as expenses. (These requirements

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[7] Although transactions and other events associated with the governmental funds are reported in the fund financial statements using the current financial resources and modified accrual measurement focus and basis of accounting (MFBA), they are reported in the government-wide financial statements using the economic resources and accrual MFBA, usually as governmental activities. That *conversion* from one MFBA to another is explained through the presentation in the governmental fund financial statements of a summary reconciliation to governmental activities in the government-wide financial statements. See the further discussion of those reconciliations in chapter 10, "Net Position and Financial Statement Reconciliations."

[8] There are other differences between resource inflow recognition in the governmental funds and that in a government's other financial statements (such as in the government-wide financial statements), but those differences arise from the differences in measurement focus, rather than from differences in basis of accounting. That is, a measurement focus on economic resources recognizes different transactions than does a measurement focus on current financial resources.

for reporting charges for uncollectible revenues are explained in GASB Statement No. 34 footnote 41; GASB Statement No. 33 paragraphs 16 and 18, as amended; and the GASB *Implementation Guide 2015-1* [GASB IG 2015-1] question 7.40.3.) (See also question 7.70.3 of the GASB IG 2015-1 that discusses reporting the change in an uncollectible loan allowance account as an expense and question Z.33.5 for a discussion of the accounting for uncollectible nonexchange revenues.)

6.16 The remainder of this section on the accounting for revenues primarily discusses how to recognize various types of revenues using the economic resources measurement focus and accrual basis of accounting. In the governmental funds, the accrual-based recognition of revenue generally should be modified for the availability criterion as discussed in paragraphs 6.12–.13. The remainder of this section also discusses some specific accounting and financial reporting requirements in governmental funds that go beyond the general recognition standards for those funds.

Nonexchange Transactions

6.17 GASB Statement No. 33, as amended, establishes accounting and financial reporting standards for nonexchange transactions. It identifies four classes of nonexchange transactions based on shared characteristics that affect the timing of recognition:

a. *Derived tax revenues.* These result from assessments imposed on exchange transactions (for example, income taxes, sales taxes, and other assessments on earnings or consumption).

b. *Imposed nonexchange revenues.* These result from assessments imposed on nongovernmental entities, including individuals, other than assessments on exchange transactions (for example, property taxes and fines).

c. *Government-mandated nonexchange transactions.* These occur when a government at one level provides resources to a government at another level and requires the recipient to use the resources for a specific purpose (for example, federal programs that state or local governments are mandated to perform).

d. *Voluntary nonexchange transactions.* These result from legislative or contractual agreements, other than exchanges, entered into willingly by the parties to the agreement (for example, certain grants and private donations).

6.18 GASB Statement No. 33 paragraph 11, requires recognition of nonexchange transactions unless the transactions are not measurable or are not probable of collection. (GASB Statement No. 33 states that *measurable* means reasonably estimable and that *probable* means the future event(s) are likely to occur.) Table 6-1 presents the asset, liability, deferred inflows of resources, and revenue recognition requirements for nonexchange transactions. Additional details about the general recognition standards for nonexchange transactions are provided in paragraphs 6.19–.24. Table 6-1 provides references to the paragraphs in this chapter in which the recognition for particular transactions types are discussed.

Table 6-1

Asset and Revenue Recognition: Nonexchange Transaction Reporting

		Revenue Recognition[a,b]	
Class of Nonexchange Transaction	***Asset Recognition—Both Accrual and Modified Accrual Bases of Accounting***	***Accrual Basis of Accounting***	***Modified Accrual Basis of Accounting***
Derived tax revenues,[c] which generally include income and sales taxes and similar assessments on earnings or consumption (paragraphs 6.25–.28)	Receivables when underlying exchange transaction occurs or cash when the resources are received, whichever is first	When the underlying exchange occurs	When the underlying exchange occurs, subject to *availability* criterion
Imposed nonexchange revenues, which generally include property taxes (paragraphs 6.29–.31), fines (see paragraph 6.40), and certain fees (paragraphs 6.41–.42)	Receivables when the government has an enforceable legal claim to the resources or cash when the resources are received, whichever is first[d]	When use of the resources is required or first permitted by time requirements[e] in enabling legislation, or at the same time as the assets if there are no time requirements	When use of the resources is required or first permitted by time requirements[e] in enabling legislation, or at the same time as the assets if there are no time requirements, subject to *availability* criterion
Government-mandated and voluntary nonexchange transactions,[f] which generally include most intergovernmental revenues (paragraphs 6.32–.35) and certain private donations and promises (pledges) of future donations (paragraphs 6.37–.39), including endowments (paragraph 6.36)	Receivables when all applicable eligibility requirements[g] are met or cash when the resources are received, whichever is first Promises from nongovernmental entities also should be verifiable	When all applicable eligibility requirements[g] are met (For endowments, time requirements are met when resources are received. See paragraph 6.36.)	When all applicable eligibility requirements[g] met, subject to *availability* criterion (For endowments, time requirements are met when resources are received. See paragraph 6.36.)

Asset and Revenue Recognition: Nonexchange Transaction Reporting—*continued*

[a] Purpose restrictions, which specify the purpose for which resources should be used, do not affect when revenue from a nonexchange transaction is recognized. Instead, they affect the reporting of net position or fund balance. See paragraph 6.19.

[b] The paragraphs referenced in column one include guidance on recognizing deferred inflows of resources. Also see chapter 2, "Financial Reporting."

[c] If derived tax revenues have time requirements, asset and revenue recognition should be consistent with the requirements for imposed nonexchange revenue transactions.

[d] Paragraph 17 of GASB Statement No. 33 provides that for some governments, the enforceable legal claim to property taxes does not arise until the period after the period for which the taxes are levied. Those governments should recognize property taxes receivable in the same period that revenues are recognized.

[e] See paragraph 6.19 for a definition of time requirements. Note also the presumption of time requirements for nonexchange transactions between governments discussed in paragraph 6.21.

[f] The recognition standards for government-mandated and voluntary nonexchange transactions are the same despite the involuntary versus voluntary characteristics of the transactions.

[g] See paragraph 6.20 for a listing of eligibility requirements.

6.19 GASB Statement No. 33, as amended, distinguishes between two kinds of stipulations on the use of resources: time requirements and purpose restrictions. Time requirements specify the period (or periods) when resources are required to be used or when use may begin, or require that the resources be maintained intact as specified by the provider. Time requirements affect the timing of recognition of nonexchange transactions. Resources received before time requirements are met but after all other eligibility requirements have been met should be reported as a deferred inflow of resources by the recipient. Purpose restrictions specify the purpose for which the resources should be used. Purpose restrictions do not affect when revenue from a nonexchange transaction is recognized; instead, they affect the reporting of net position or fund balance. (See chapter 10, "Net Position and Financial Statement Reconciliations.")

6.20 For government-mandated and voluntary nonexchange transactions, the provider may establish eligibility requirements that affect the recognition of revenue. Resources received before eligibility requirements are met (excluding time requirements) should be reported as liabilities by the recipient. The four types of eligibility requirements are as follows:

a. *Required characteristics of recipients.* The provider specifies certain characteristics for the recipient or secondary recipient. For example, under a certain federal program, recipients are required to be states and secondary recipients are required to be counties.

b. *Time requirements.* See the definition in paragraph 6.19.

c. *Reimbursements.* The provider offers resources on a reimbursement (*expenditure-driven*) basis and the recipient has incurred allowable costs under the applicable program.

d. *Contingencies (applies only to voluntary nonexchange transactions).* The provider offers resources contingent upon a specified action of the recipient, and that action has occurred. For example, the recipient is required to raise a specific amount of resources from third parties or to dedicate its own resources for a specified purpose and has complied with those requirements.

6.21 Sometimes a provider in a government-mandated or voluntary nonexchange transaction does not specify time requirements. If the provider is *not* a government, no time requirement is presumed, and the entire award should be recognized in the period when all of the applicable eligibility requirements are met (applicable period). Conversely, if the provider is a government (including the federal government), GASB Statement No. 33, as amended, presumes a time requirement if one is not specified. The entire award should be recognized in the period when all applicable eligibility requirements are met (applicable period). The presumed applicable period is the immediate provider's fiscal year and begins on the first day of that year. (GASB chose the first day of the immediate provider's fiscal year because it is the effective date of that government's appropriation to disburse the resources.) If a provider government has a biennial budgetary process, each year of the biennium should be considered a separate applicable period, and the recipients should allocate one-half of the resources appropriated for the biennium to each applicable period, unless the provider specifies a different allocation. The following example is provided in the nonauthoritative "Basis for Conclusions" of GASB Statement No. 33—if a federal grant that a state passes through to counties does not specify a time requirement, the applicable period for state revenue recognition purposes begins on the first day of the federal fiscal year and the applicable period for county revenue recognition purposes begins on the first day of the state fiscal year.

6.22 Promises from nongovernmental entities to provide cash or other assets are sometimes referred to as *pledges*, *promises to give*, or *promised donations*. Recipients of those promises should recognize revenues and receivables when all eligibility requirements are met, provided that the promise is verifiable and the resources are measurable and probable of collection. (See the additional discussion in paragraph 6.39 concerning promises of cash or other assets for endowments and similar transactions.)

6.23 Paragraph 26 of GASB Statement No. 33, as amended, provides guidance on the contravention of provider stipulations. After a nonexchange transaction has been recognized in the financial statements, it may become apparent that (*a*) the eligibility requirements are no longer met or (*b*) the recipient will not comply with the purpose restrictions within the specified time limit. In these circumstances, if it is probable that the provider will not provide the resources or will require the recipient to return all or part of the resources already received, the recipient should recognize a decrease in assets (or an increase in liabilities) and an expense for the amount that the provider is expected to cancel or reclaim. These contraventions of provider stipulations differ from the uncollectible receivables discussed in paragraph 6.15 and thus are not reported as revenue reductions. (Chapter 8, "Expenses or Expenditures and Liabilities," discusses the GASB standards for recognizing expenditures and liabilities in governmental funds.)

6.24 GASB Statement Nos. 33, as amended, and 36 illustrate the application of their standards to various nonexchange transactions in nonauthoritative appendixes. Paragraphs 13 and 17 of the GASB IG 2015-1 discuss various issues relating to nonexchange transactions.

Income, Sales, and Similar Taxes

6.25 Income taxes, sales taxes, and other assessments on earnings or consumption generally meet the definition of derived tax revenues. Consequently, under the accrual basis of accounting, revenues are recognized when the underlying exchange transaction occurs, for example, when a retail sale is made or when a taxpayer earns taxable income. Receivables for uncollected revenues are reported when revenue is recognized. Resources received in advance should be reported as liabilities in the period of exchange. Derived tax revenues generally do not have time requirements. However, if they apply, asset and revenue recognition should be consistent with the requirements for imposed nonexchange revenue transactions.

6.26 The nonauthoritative appendix of illustrative examples in GASB Statement No. 33 indicates that, from a practical standpoint, a government will likely base the amount to be recognized as sales or other consumption tax revenues on total taxable activities reported or estimated for the weeks or quarters that make up the government's fiscal year. That appendix further indicates that, from a practical standpoint, a government will likely base the amount to be recognized as income tax revenue on the amount of withholding and estimated tax payments made during the government's fiscal year, adjusted for post-fiscal-year final settlements (additional payments and refunds). Those *practical* explanations do not change the standard for the recognition of those revenues but, rather, recognize the application of materiality considerations. A government that recognizes those revenues following the *practical* approaches has to be able to demonstrate that the effects do not materially misstate the revenue that would be recognized using the *underlying event* standard (for example, because of a high number of unusual transactions).

6.27 Because of the timing of a government's fiscal year in relation to the taxpayers' income tax year, many governments will have to estimate the final settlement amounts for additional payments and refunds. GASB standards provide no specific guidance for making those measurements. GASB standards also do not address whether the estimated amount of taxes to be refunded should be reported as liabilities or, instead, as a reduction of related receivables. Further, question Z.33.9 of the GASB IG 2015-1 indicates that sales and income taxes and other resources to be recovered in tax audits should be recorded, if measurable, in the same period as the underlying exchange regardless of when they will be collected (subject to the availability criterion in governmental funds).

6.28 For income, sales, and similar taxes reported in governmental funds, the estimated amount of any taxes to be refunded should be reported in the funds (either as liabilities or as a reduction of related receivables as discussed in paragraph 6.27). Those amounts are reported in the governmental funds (even though they may not be payable in the short term) because they arise from reducing revenue as provided for in GASB Statement No. 33 paragraph 16 as amended or from reducing deferred inflows of resources.

Property Taxes

6.29 Property taxes, which are addressed in NCGA Statement 1, as amended and interpreted by NCGA Interpretation 3, *Revenue Recognition—Property Taxes*, GASB Statement No. 33, as amended, and GASB Interpretation No. 5, *Property Tax Revenue Recognition in Governmental Funds—an interpretation of NCGA Statement 1 and an amendment of NCGA Interpretation 3*, generally meet the definition of imposed nonexchange revenues. Consequently, under the accrual basis of accounting, governments should recognize property tax revenues in the period for which the taxes are levied, which often can be determined through the budgetary process. (That is, property tax levies often are made to finance a particular fiscal period.)

6.30 Property tax receivables should be reported the earlier of (*a*) when revenue is recognized as discussed in paragraph 6.29 and (*b*) when the enforceable legal claim to the taxes arises, which generally is specified in enabling legislation. Many governments refer to the date the enforceable legal claim arises as the *lien date* (even though a lien is not formally placed on the property at that date), whereas other governments use a different term, such as the *assessment date*. Property tax receivables recorded or payments received before revenues are recognized are reported as deferred inflows of resources.

6.31 To modify property tax revenue recognition in governmental funds for the availability criterion, NCGA Statement 1, as amended and interpreted, stipulates that *available* means "collected within the current period or expected to be collected soon enough thereafter to be used to pay liabilities of the current period." However, the time after the current period should not exceed sixty days unless there are unusual circumstances that justify a longer period, and those circumstances are disclosed as discussed in paragraph 6.88.

Intergovernmental Revenues

6.32 Intergovernmental revenues, such as grants, entitlements, shared revenues, and appropriations from a primary government to a component unit, generally meet the definition of either government-mandated or voluntary nonexchange transactions. (Some intergovernmental revenues may arise from exchange or exchange-like transactions. For example, a county may house state inmates in its correctional facility for a charge that essentially equals the value the state receives from the service.) Although most intergovernmental revenues involve the receipt of cash for operating purposes, some involve the receipt of capital assets[9] or cash for capital purposes. The following recognition standards apply to the accrual-based recognition of intergovernmental revenues from government-mandated and voluntary nonexchange transactions, regardless of the nature or purpose of the resources, except for resources received as endowments and similar transactions as discussed in paragraph 6.36.

6.33 Under the accrual basis of accounting, governments should recognize intergovernmental revenue from government-mandated and voluntary nonexchange transactions when all applicable eligibility requirements—required characteristics of recipient, time requirements, reimbursements, and contingencies (for voluntary nonexchange transactions)—are met. (See paragraph 6.21 concerning the presumption of a time requirement if a governmental provider does not specify a time requirement.) Receivables are reported at the same time as revenue unless the payment already has been received. Question Z.33.16 of the GASB IG 2015-1 discusses the effect of the provider government's appropriation process on the recognition of grant revenue. Resources received before the eligibility requirements are met, excluding time requirements, should be reported as a liability by the recipient; whereas, resources received before time requirements are met, but after all other eligibility requirements have been met, should be reported as deferred inflows of resources.

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[9] As discussed in paragraph 6.12, governmental funds do not report revenues for donations of capital assets unless the asset donated is being held for sale.

6.34 GASB Statement No. 36 applies the revenue recognition requirements discussed in paragraph 6.33 to shared revenues regardless of whether the provider government's financing source for those amounts is derived tax revenues or imposed nonexchange revenues. Some shared revenues require an annual appropriation before they can be disbursed. In those situations, as discussed in paragraph 6.21, the entire award should be recognized in the period that begins on the first day of the provider government's fiscal year, provided that all other applicable eligibility requirements are met. Other shared revenues do not require an annual appropriation but instead are disbursed because of continuing appropriations. (Continuing appropriations are appropriations that, once established, are automatically renewed without further legislative action, period after period, until altered or revoked.) The nonauthoritative appendixes to GASB Statement No. 36 explain that when a provider government shares resources under a continuing appropriation, the time eligibility requirement is continuously (automatically) met. Therefore, those nonauthoritative appendixes explain, shared revenues that are remitted to recipients under continuing appropriations should be recognized as the event underlying the shared revenue source occurs (for example, shared sales taxes are recognized as sales occur), subject to any other applicable eligibility requirements. GASB Statement No. 36 states that in measuring the amount of shared revenues disbursed through continuing appropriations, the recipients may rely on periodic notification by the provider government of the accrual-basis information necessary for compliance. If notification by the provider government is not available in a timely manner, recipient governments should use a reasonable estimate of the amount to be accrued.

6.35 As discussed in paragraph 6.23, GASB Statement 33 paragraph 26 provides guidance on recognizing a decrease in assets or an increase in liabilities if, in the period after a nonexchange transaction has been recognized in the financial statements, it becomes apparent that eligibility requirements are no longer met or purpose restrictions will not be met. In addition, if intergovernmental grant revenues are subject to adjustment as, for example, when questioned costs from other than not meeting eligibility requirements or purpose restrictions are identified during a grant compliance audit, the government should consider whether a loss contingency exists. If that is the case, the government should consider whether a liability (or a decrease in receivables) should be recorded or whether disclosure (for example, of a material violation of a finance-related legal or contractual provision) is required.

Endowments and Similar Transactions

6.36 In some government-mandated and voluntary nonexchange transactions, a provider transmits cash or other assets with the stipulation (time requirement) that the resources cannot be sold, disbursed, or consumed until after a specified number of years have passed or a specific event has occurred, if ever. In the interim, the provider requires or permits the recipient to benefit from the resources—for example, by investing or exhibiting them. Examples of such transactions include permanently nonexpendable additions to endowments and other trusts; term endowments; and contributions of works of art, historical treasures, and similar assets. Under the accrual basis of accounting, GASB Statement No. 33 paragraph 22 as amended and GASB Statement No. 34 paragraph 28 require revenues for these transactions to be recognized when the resources are received, provided that all eligibility requirements have been met.[10] For these transactions, the time requirement is met as soon as the recipient begins to honor the provider's stipulation not to sell, disburse, or consume the resources and continues to be met for as long as the recipient honors that stipulation. (If such works of art, historical treasures, or similar assets are not capitalized as permitted by GASB Statement No. 34 paragraph 27, governments should recognize an expense equal to the amount of revenue recognized.)

Donations and Promises of Future Donations From Nongovernmental Entities

6.37 Donations of cash or other assets from nongovernmental entities, including individuals, are private donations. Private donations generally meet the definition of voluntary nonexchange transactions. (Some private donations may arise from exchange or exchange-like transactions. For example, a donor may give a state university a research grant in return for patent rights to the research results, which may be an exchange of essentially equal value.) Private donations may be received with or without purpose restrictions or eligibility requirements and may be received as promises of future donations.

6.38 Under the accrual basis of accounting, governments should recognize receivables and revenues from private donations that are voluntary nonexchange transactions when all applicable eligibility requirements—required characteristics of recipient, time requirements, reimbursements, and contingencies—are met. Resources received before the eligibility requirements are met, excluding time requirements, should be reported as a liability by the recipient, whereas resources received before time requirements are met, but after all other eligibility requirements have been met, should be reported as deferred inflows of resources.

6.39 Under the accrual basis of accounting, promises of future donations from nongovernmental entities should be recognized as revenues and receivables when all eligibility requirements are met, provided that the promise is verifiable and the resources are measurable and probable of collection. (Question Z.33.19 of the GASB IG 2015-1 indicates that long-term receivables for nonexchange revenues may be measured using either discounted present values or future values.) However, promises of cash or other assets for endowments and similar transactions (as discussed in paragraph 6.36) should not be recognized as receivables or as revenues before the assets are received.

Fines

6.40 Fines, for example, for violations of traffic or environmental laws, generally meet the definition of imposed nonexchange revenues. Consequently, under the accrual basis of accounting, receivables for fines should be recognized when the government has an enforceable legal claim to the resources. (See the discussion of the recognition of fines in question Z.33.10 of the GASB IG 2015-1.) Revenues should be recognized at the same time as the assets (amounts received or receivables) or, if there are time requirements, in the period the use of the resources is required or first permitted by those time requirements.

Nonexchange Fees

6.41 GASB Statement No. 33 paragraph 10 indicates that some nonexchange revenues may be termed *fees* or *charges*—terms normally used for

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[10] See footnote 9.

exchange and exchange-like transactions. Fees that arise from nonexchange transactions generally meet the definition of imposed nonexchange revenues. Consequently, under the accrual basis of accounting, receivables for nonexchange fees should be recognized when the government has an enforceable legal claim to the resources. Revenues should be recognized at the same time as the assets (amounts received or receivables) or in the period the use of the resources is required or, if there are time requirements, first permitted by those time requirements. Such fees received or receivable before revenue is recognized due to timing requirements should be reported as deferred inflows of resources.

6.42 The GASB-established definitions of exchange and exchange-like transactions, the guidance provided in question Z.33.2 of the GASB IG 2015-1,[11] and professional judgment, depending on the facts and circumstances surrounding the transactions, affect the determination of whether particular fees arise in whole or in part from nonexchange transactions or, instead, exchange or exchange-like transactions. To ensure intra- and inter-period consistency in recognizing the revenue from particular fees as nonexchange or, instead, as exchange and exchange-like transactions, governments usually establish policies or practices concerning such determinations. However, the determination may make little practical difference in the absence of time requirements for the use of the fee resources. When there are no time requirements, imposed nonexchange revenues generally are recognized at essentially the same time as exchange transaction revenues (that is, when the government has an enforceable legal claim to the resources versus when earned). (See also the section on user fees starting at paragraph 6.48.)

Pass-Through Grants

6.43 Governmental entities often receive pass-through grants—grants and other financial assistance to transfer to or spend on behalf of a secondary recipient. All cash pass-through grants received by a government should be reported in its financial statements. As a general rule, cash pass-through grants should be recognized as revenue (using the provisions of GASB Statement No. 33, as amended) and expenses or expenditures in a governmental, proprietary, or trust fund. In those infrequent cases in which a recipient government serves only as a cash conduit as defined in GASB Statement No. 24, *Accounting and Financial Reporting for Certain Grants and Other Financial Assistance*, paragraph 5, the pass-through grant should be reported in an agency fund.

Update 6-2 *Fiduciary Activities*

GASB Statement No. 84, *Fiduciary Activities*, establishes criteria for identifying and reporting fiduciary activities. The criteria for identification of fiduciary activities primarily focuses on (*a*) whether a government controls the assets of the fiduciary activity and (*b*) the beneficiaries with whom a fiduciary relationship exists.

Governments with activities meeting the criteria will present a statement of fiduciary net position and a statement of changes in fiduciary net position, with certain exceptions.

[11] Question Z.33.2 of the GASB *Implementation Guide 2015-1* (GASB IG 2015-1) indicates that drivers' licenses and business permits generally are exchange or exchange-like transactions because the cost of a license or permit does not exceed the value of the services and rights received in exchange.

There are four classifications of fiduciary funds described in GASB Statement No. 84: (1) pension (and other employee benefit) trust funds, (2) investment trust funds, (3) private-purpose trust funds, and (4) custodial funds. Custodial funds should report fiduciary activities that are not held in a trust or equivalent arrangement that meets specific criteria. Note that agency funds will no longer be reported upon application of this statement.

The statement was issued in January 2017 and is effective for fiscal years beginning after December 15, 2018. Earlier application is encouraged.

Upon its effective date, GASB Statement No. 84 will affect the guidance in this chapter.

The full text of the statement is available on GASB's website at www.gasb.org.

On-Behalf Payments for Fringe Benefits and Salaries

6.44 GASB Statement No. 24, as amended, provides standards for recognizing the effect of on-behalf payments for fringe benefits and salaries, which are direct payments made by one entity (the paying entity or paying government) to a third-party recipient for the employees of another, legally separate entity (the employer entity or employer government). However, the provisions of GASB Statement No. 24 do not apply to payments that are legally required to be made directly to a pension plan for pensions of the employees of another entity or entities, including benefit payments made directly to the employees of another entity as the pensions come due. GASB Statement Nos. 68 and 73 provide guidance for accounting and financial reporting for these payments.

Contributed Services

6.45 Governments often benefit from various *contributed services*. For example, a small city without a police force may receive law enforcement coverage from the state police, a state court may receive office space from county governments, or a county library may use volunteers to supplement its staff. Those services may be provided at no cost, or at a cost that is lower than its value. Sometimes, contributed services arise from *on-behalf payments*—that is, one entity may pay a third-party recipient to provide services to the government. For example, a third party may pay telephone companies to provide free Internet access to school districts. GASB has not established standards that require a government to recognize revenue (or expenses or expenditures) in its financial statements for contributed services (GASB Statement No. 33, as amended, specifically excludes contributed services from its scope).

Exchange Transactions

6.46 Under the accrual basis of accounting, revenues that result from exchange and exchange-like transactions are recognized when the exchange takes place. Paragraphs 23–28 in GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, as amended, provide guidance on revenue recognition for exchange transactions.

Investment Earnings

6.47 Chapter 5, "Investments, Certain Equity Interests, and Derivatives," discusses the accounting, financial reporting, and auditing considerations for investment earnings.

User Fees

6.48 Governments have fees that result from exchange and exchange-like transactions. Such fees are referred to as *user fees* and may include amounts charged for the use of various services, such as

- public utilities (for example, water, sewer, gas, electric, storm water, and trash disposal).
- recreation and cultural operations (for example, sports facilities, convention centers, swimming pools, golf courses, and amusement parks).
- public facilities (for example, parking garages, toll roads and bridges, airports, and docks).

6.49 As discussed in paragraph 6.42, the GASB-established definitions of exchange and exchange-like transactions, the guidance provided in question Z.33.2 of the GASB IG 2015-1,[12] and professional judgment, given the facts and circumstances surrounding the transactions, affect the determination of whether certain fees arise in whole or in part from nonexchange transactions or, instead, exchange or exchange-like transactions. This may affect, for example, regulatory and professional license and permit fees, system development fees, and impact fees. (System development fees are charged to join or extend an existing utility system; they also are known as tap or *connection fees*. System development fees may relate to the cost to physically connect to the system, or they may substantially exceed the cost to connect. Governments charge property developers impact fees to help defray the government's costs that result from increased development.)

6.50 Some user fees are billed and collected essentially at the same time they are earned, such as fees for some parking garages or toll roads. Other user fees, such as charges for some electric, water, and gas utility services, are billed and collected after the service is delivered (and thus after the exchange takes place). Still other user fees, such as charges for some sewer and trash utility services, are billed and collected before the service is delivered (and thus before the exchange takes place). When user fees are not billed and collected at the same time they are earned, a government may need to record receivables for unbilled services or liabilities for advance payments, depending on whether the fees are earned before they are billed and collected or vice versa. (See also the discussion in chapter 8 concerning customer and developer deposits.) Further, depending on the billing characteristics, the amounts reported as receivables may need to go beyond simply the amounts billed but not collected. For example, if utility customers are billed at the end of each quarter based on actual (not estimated) meter readings, but the meter readings are spread evenly throughout the quarter, an average of forty-five days' service for the entire customer base is unbilled at the end of the accounting period. Also, consideration may be required as to the characteristics of the billing period, such as seasonal usage.

6.51 A government may apply the provisions of paragraphs 477–500 of GASB Statement No. 62, as amended, to activities reported in business-type activities that have regulated operations that meet all of the criteria in paragraph 476 of GASB Statement No. 62. If some of a business-type activity's operations are regulated and meet the criteria of paragraph 476 of GASB Statement

[12] See footnote 11.

No. 62 and the entity elects to apply paragraphs 477–500 of GASB Statement No. 62, as amended, those provisions should be applied to only that portion of the business-type activity's operations. Authoritative accounting pronouncements that apply to business-type activities in general also apply to regulated business-type activities. However, regulated business-type activities subject to paragraphs 477–500 of GASB Statement No. 62, as amended, should apply those paragraphs instead of any conflicting provisions of standards in other authoritative pronouncements. GASB Statement No. 62 permits enterprise funds and business-type activities to continue applying, as nonauthoritative accounting literature, post-November 30, 1989, FASB pronouncements that do not conflict with or contradict GASB pronouncements.

6.52 Generally, the type of regulation covered by Paragraphs 480–483 of GASB Statement No. 62, as amended, permits rate (prices) to be set at levels intended to recover the estimated costs of providing regulated services or products. In rate-regulated enterprises, revenues intended to cover some costs are provided either before or after the costs are incurred. If regulation provides assurance that incurred costs will be recovered in the future, enterprises are required to capitalize those costs. If current recovery is provided for costs that are expected to be incurred in the future, enterprises are required to recognize those current receipts as deferred inflows of resources. (See the further discussion of the accounting for regulated operations in the section on utilities in chapter 12, "Special-Purpose and State Governments.")

Risk Financing Activities

6.53 Chapter 8 discusses the accounting, financial reporting, and auditing considerations for an entity's risk financing activities, including recognition of (*a*) interfund charges received by the general fund or internal service funds that account for those risk financing activities and (*b*) insurance recoveries. In addition, chapter 12 discusses the accounting, financial reporting, and auditing considerations for public entity risk pools, including revenue recognition.

Defined Benefit Pension Plan and OPEB Plan Contributions

6.54 Chapter 14 discusses the accounting, financial reporting, and auditing considerations for certain postemployment benefit plans, including OPEB plans. Chapter 13, "Defined Benefit Pension Plans (Plan & Employer Considerations)," discusses the accounting, financial reporting, and auditing considerations for defined benefit pension plans that are in the scope of GASB Statement No. 67.

Sales and Leases of Capital Assets

6.55 Reported amounts arising from sales of capital assets should be recognized when the exchange takes place; that is, when title to the property transfers. In the government-wide, proprietary fund, and fiduciary fund financial statements, the amount recognized should be the difference between the sales price of the asset and its carrying amount. As shown in the nonauthoritative illustrative financial statements in appendix B7-1 to the GASB IG 2015-1, the amount recognized in the governmental fund financial statements generally is the proceeds from the sale of the asset. Proceeds from the sale of general capital assets normally are recorded in the general fund, although some bond indentures, state or local laws, or grant contracts may require that the proceeds be recorded in a related debt service fund, special revenue fund, or capital projects fund.

6.56 The accounting and financial reporting for lease agreements is described in paragraphs 211–271 of GASB Statement No. 62, as amended, and NCGA Statement 5, *Accounting and Financial Reporting Principles for Lease Agreements of State and Local Governments*, as amended. Chapter 7, "Capital Assets" and chapter 8 discuss the accounting and financial reporting for capital and operating leases, respectively, when the government is the lessee. Those chapters provide certain details on the provisions of NCGA Statement 5, as amended, GASB Statement No. 13, *Accounting for Operating Leases With Scheduled Rent Increases*, and GASB Statement No. 62, as amended. The chapter 12 section on financing authorities discusses leases between a primary government and its component units.)

Sales of Receivables and Future Revenues

6.57 GASB Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues*, as amended, provides standards on recognizing and displaying sales of existing governmental receivables (for example, delinquent property taxes) and sales of future revenues, such as future revenues due from commercial tobacco companies as a result of a settlement of a lawsuit brought by the states.[13] GASB Statement No. 48 discusses exchanges by governments of interests in their expected cash flows from collecting specific receivables or specific future revenues for immediate cash payments. The statement provides standards for determining whether such exchanges should be classified as sales or as collateralized borrowing transactions. The statement further provides that assets and future revenues transferred in an intra-entity transaction should be reported at their carrying value; that is, they should not be revalued (see chapter 9 for further discussion of the provisions of GASB Statement No. 48 that relate to intra-entity sales of receivables and future revenues).

6.58 GASB Statement No. 48 makes a basic distinction between sales of receivables and future revenues and the pledging of receivables and future revenues to repay a borrowing (a collateralized borrowing). It establishes that a transaction is a collateralized borrowing unless it meets criteria that demonstrate that the government is no longer actively involved with the receivables or future revenues it has transferred to the other party. Paragraphs 6–10 of GASB Statement No. 48 set forth the criteria for determining that a government does not continue to be involved.

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[13] GASB Technical Bulletin (TB) No. 2004-1, *Tobacco Settlement Recognition and Financial Reporting Entity Issues*, paragraphs 16–23 were superseded by GASB Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues*, as amended. However, entities that consummated transactions that qualify as sales of such revenues prior to the effective date of GASB Statement No. 48—financial statements for periods beginning after December 15, 2006—do not have to retroactively apply the deferral provisions in paragraph 14 of the statement. The practical effect of that provision is that entities that previously recognized all of the revenue from the sale of tobacco settlement revenues upon their sale do not have to restate their financial statements to defer the revenue from the sale that otherwise would be required by GASB Statement No. 48. GASB Statement No. 65 further amends paragraph 14 of GASB Statement No. 48 by requiring the transferor government to report the proceeds from the sale of future revenue as a deferred inflow of resources in both the government-wide and fund financial statements if (*a*) the transaction was with parties outside the financial reporting entity and (*b*) the future revenue sold was not recognized previously because the event that would have resulted in revenue recognition had not yet occurred (for example, tobacco settlement revenues). Chapter 12, "Special-Purpose and State Governments," of this guide (in the section on state governments) discusses the provisions of GASB TB No. 2004-1, including the recognition of assets and revenue for tobacco settlement resources prior to the effective date of GASB Statement No. 48.

6.59 If a transaction does not meet the criteria to be a sale, the government pledging the receivables or future revenues should report the proceeds it receives as a liability, not as revenue. It continues to report pledged receivables as assets and pledged revenues as revenues, as appropriate under generally accepted accounting principles (GAAP). The liability is reduced as cash is collected from the pledged receivables or revenues and transferred to the other party. If the other party to the transaction—the lender (transferee)—also is a government, it should report a receivable for the amounts paid to the pledging government. The receivable is reduced as the government transferee receives the payments from the pledging government.

6.60 As noted in paragraphs 11–12 of GASB Statement No. 48 as amended, receivables that are sold should be removed from the assets in the selling government's financial statements. If there is a difference between the proceeds received by the selling government and the amount of the receivables reported on its financial statements (the carrying value), the difference is reported as a gain or loss in the accrual-based financial statements (and as revenue in the modified-accrual-based governmental fund financial statements). If the buyer of a receivable is a government that is not a part of the selling government's financial reporting entity, it adds a receivable to its financial statements equal to the purchase price.

6.61 As noted in paragraphs 13–14 of GASB Statement No. 48, as amended, in a sale of future revenues, rather than being reported as revenue at the time of the sale, the proceeds from the sale of a future revenue source should be reported as a deferred inflow of resources or revenue in both the government-wide and fund financial statements. Generally, revenue should be recognized over the life of the sale agreement. In each year of the agreement, a portion of the deferred inflow of resources would be recognized as revenue. The purchasing government in a sale of future revenues (if it is not part of the reporting entity of the selling government) recognizes the acquisition at cost and amortizes the amount over the life of the agreement and realizes receivables and revenue when the recognition criteria under GAAP are met—the revenue stream now belongs to the purchasing government. Paragraph 16 of GASB Statement No. 48 as amended discusses amortization of the deferred amounts.

6.62 When accounting for the transfer of capital and financial assets and future revenues within the same financial reporting entity, the transferee should recognize the assets or future revenues received at the carrying value of the transferor. For example, in an intra-entity sale of receivables, the transferee government should recognize the receivables acquired at the carrying value of the transferor government. The difference between the amount paid (exclusive of amounts that may be refundable) and the carrying value of the receivables transferred should be reported as a gain or loss by the transferor and as a revenue or expenditure or expense by the transferee in their separately issued statements but reclassified as transfers or subsidies, as appropriate, in the financial statements of the reporting entity.

6.63 In an intra-entity sale of future revenues, the transferor government has reported no carrying value for the rights sold because the asset recognition criteria have not been met. Therefore, the transferee government should not recognize an asset and related revenue until recognition criteria appropriate to that type of revenue are met. Instead, the transferee government should report the amount paid as a deferred outflow of resources to be recognized in expense over the duration of the sale agreement. The transferor government should report the amount received from the intra-entity sale as a deferred inflow of resources in its government-wide and fund financial statements and recognize the amount as revenue over the duration of the sale agreement.

Special Assessments

6.64 Service-type special assessments usually involve the provision of basic or additional services to property owners on an assessment basis. The types of services provided under these arrangements include street lighting and street cleaning, weed cutting, and snow removal. Service-type special assessments that are exchange or exchange-like transactions should be accounted for like user fees in that accrual-based revenue should be recognized when the exchange takes place. Revenues from service-type special assessments that are nonexchange transactions should be recognized in accordance with the guidance in GASB Statement No. 33, as amended. For the fund financial statements, GASB Statement No. 6, *Accounting and Financial Reporting for Special Assessments*, paragraph 14 states that service-type special assessment transactions should be reported in the fund type that best reflects the nature of the transactions, usually the general fund, a special revenue fund, or an enterprise fund.

6.65 Governments sometimes provide capital improvements to benefit a particular group of property owners rather than the general citizenry by creating special assessment districts, providing or arranging financing, and billing and collecting the assessments. The payments made by the property owners who benefit are known as capital improvement special assessments. The receipt of capital improvement special assessments and the payment of the related debt are accounted for differently depending on whether the government is obligated in some manner to assume the payment of related debt service in the event of default by the property owners, as defined in GASB Statement No. 6 paragraph 16. If the government is not obligated in some manner to assume the payment of special assessment debt if property owners default, the receipt of the assessments and the payment of the related debt are accounted for in an agency fund.

6.66 However, if the government is obligated in some manner to assume the payment of special assessment debt in the event of default by the property owners, GASB Statement No. 6 paragraph 15 states that the receipt of the assessments and the payment of the related debt should be reported in a debt service fund, if one is required by NCGA Statement 1 paragraph 30. Revenue from capital improvement special assessment transactions that are exchange or exchange-like transactions should be recognized on the accrual basis of accounting. Capital improvement special assessment receivables should be reported at the time of the levy. (See the additional discussion of capital improvement special assessment capital assets in chapter 7 and special assessment debt in chapter 8.)

Amounts Collected for Individuals, Other Entities, or Other Funds

6.67 Some governments collect and distribute cash and other assets for the benefit of individuals or other entities, including other governments. As examples, a state social services department may collect child support payments from noncustodial parents to distribute to custodial parents, or a county tax collector may collect property taxes from property owners and distribute those taxes among the taxing jurisdictions within the county. Such transactions often are reported in private-purpose trust funds or agency funds. Private-purpose trust funds generally are distinguished from agency funds by the existence of a trust agreement, the degree of management involvement, and the length of time that the resources are held. Private-purpose trust and agency funds use the accrual basis of accounting to recognize resource inflows. (See the further discussion of these fund types in chapter 2.)

6.68 Agency funds involve accounting for amounts held as an agent for individuals, private organizations, or other governments. Agency funds should not be used to report resources that support the government's own programs. If an agency fund is being used as a clearing account to distribute financial resources to other funds (as well as other entities), then, the portion that pertains to other funds of the government should be reported as assets in the appropriate funds, not in agency funds (GASB Statement No. 34 paragraph 111).

Activity Statement Classifications

Government-Wide Statement of Activities

6.69 GASB Statement No. 34, as amended, requires reported resource inflows to be classified as program or general revenues unless they are required to be classified as contributions to term and permanent endowment principal, contributions to permanent fund principal, special items, or extraordinary items. See the GASB-established formatting requirements for the government-wide statement of activities in chapter 2.

6.70 GASB Statement No. 34 paragraph 47 provides general rules for whether four basic sources of revenues are considered program or general revenues, as indicated in table 6-2:

Table 6-2

Program or General Revenues

Revenue Source	***Revenue Type***
Those who purchase, use, or directly benefit from the program's goods or services	Always program revenue
Parties outside the reporting government's citizens as a whole	Program revenue if restricted to a specific program; general revenue if unrestricted
All the reporting government's taxpayers	Always general revenue, even if restricted to a specific program
The governmental entity itself, for example, through investing	Usually general revenue

6.71 Program revenues derive directly from the program itself or from parties outside the reporting government's taxpayers or citizens as a whole. Program revenues are separately classified in three categories—(*a*) charges for services, (*b*) program-specific operating grants and contributions, and (*c*) program-specific capital grants and contributions:[14]

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[14] Paragraph 48 of GASB Statement No. 34, as amended, indicates that more than one column may be used to display components of a program revenue category. Further, governments may use more descriptive category headings to explain the types of program revenues being reported.

- Charges for services include transactions in which customers, applicants, or others purchase, use, or directly benefit from the goods, services, or privileges provided, or are otherwise affected by the services. Examples include charges for specific services, such as water use or trash collection; licenses and permits (such as dog licenses, liquor licenses, and building permits); assessments for street cleaning or special street lighting; fines and forfeitures; and payments from other governments that are exchange transactions. This type of program revenue should be reported in the function that generates the revenue, even if the revenue's use is restricted to another program. If it is difficult or impractical to identify the function that generates a program revenue, GASB Statement No. 34, as amended, requires the government to adopt a classification policy for assigning those revenues to a function and to apply that policy consistently.

- Program-specific operating and capital grants and contributions include revenues that arise from government-mandated and voluntary nonexchange transactions with other governments, organizations, or individuals that are restricted for use in a particular program. This type of program revenue should be reported in the function to which the revenue's use is restricted. Capital grants and contributions consist of capital assets or resources that are restricted for capital purposes—to purchase, construct, or renovate capital assets associated with a specific program. Grants and contributions that may be used either for operating expenses or for capital expenditures of the program at the discretion of the reporting government should be reported as operating grants.

6.72 Multipurpose grants (those that provide financing for more than one program) should be reported as program revenue if the amounts restricted to each program are specifically identified in either the grant award or the grant application on which the award was based. Multipurpose grants that do not provide for specific identification of the programs and amounts should be reported as general revenues. (Question 7.34.3 of the GASB IG 2015-1 discusses the classification of revenue from program-restricted multipurpose grants when an entity reports its operations in functional categories.)

6.73 All revenues are general revenues unless they are required to be reported as program revenues, contributions to term and permanent endowments, contributions to permanent fund principal, special items, or extraordinary items. All taxes, even those that are levied for a specific purpose, are general revenues and should be reported by type of tax, for example, sales tax, property tax, franchise tax, income tax. (GASB IG 2015-1 questions 7.36.1–7.36.2 explain that special assessments, unlike property taxes, are considered program revenues rather than general revenues.) General revenues should be reported after the total net expense of the government's functions.

6.74 Contributions to term and permanent endowments, contributions to permanent fund principal, special items, and extraordinary items each should be reported after the total net expense of the government's functions. According to paragraph 56 of GASB Statement No. 34 and GASB IG 2015-1 question 7.43.2, special items differ from extraordinary items in two ways. Special items should be within the control of management and are required to be only unusual in nature or infrequent in occurrence but not both. Special items are to be reported before extraordinary items. Conversely, extraordinary items are not required to be within the control of management but are required to be both unusual in nature and infrequent in occurrence. Paragraphs 45–49 of GASB Statement No. 62 provide guidance for special and extraordinary items and include the following criteria which should be met to classify an event or transaction as either unusual in nature or infrequent in occurrence.

a. *Unusual nature*—the underlying event or transaction should possess a high degree of abnormality and be of a type clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the government, taking into account the environment in which the government operates.

b. *Infrequent in occurrence*—the underlying event or transaction should be of a type that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the government operates.

GASB IG 2015-1 question 7.43.2 provides examples of special and extraordinary items.

6.75 The classification requirements for resource inflows apply to all amounts reported in the statement of activities, including amounts reported for discretely presented component units. However, because GASB Statement No. 34, as amended, does not require special-purpose governments engaged only in business-type activities to present government-wide financial statements (see chapter 12), those classifications may not be presented in the stand-alone financial statements of certain component units. Some primary governments may require their component units to include that information in their basic financial statements or in the footnotes, so that audited information is available for the reporting entity's financial statements. Other governments will infer that information from the component unit financial statements as discussed in question 7.26.6 of the GASB IG 2015-1.

6.76 Paragraph 13 of the GASB IG 2015-1 provides additional examples of the classification of specific types of revenues as program revenues or general revenues.

Governmental Fund Statement of Revenues, Expenditures, and Changes in Fund Balances

6.77 NCGA Statement 1 paragraph 110, provides that governmental fund revenues should be classified in the statement of revenues, expenditures, and changes in fund balances by fund and major revenue source, such as taxes, licenses and permits, intergovernmental revenues, charges for services, fines and forfeits, and miscellaneous. Revenues may be further classified by organization units—departments, bureaus, divisions, or other administrative agencies. Certain resource inflows are reported as other financing sources. Sales of capital assets are reported as other financing sources unless the sale meets the criteria for reporting as a special item (see paragraph 6.74 for the definition of special items). Other financing sources also are reported for the financing of capital assets under capital leases and the issuance of debt, as discussed in chapters 7 and 8, respectively. See the GASB-established formatting requirements for the governmental fund statement of revenues, expenses, and changes in fund balances in chapter 2.

6.78 Special and extraordinary items (see paragraph 6.74 for definitions), including those resulting from resource inflows, should be reported separately after "other financing sources and uses." If both special and extraordinary items occur during the same period, they should be reported separately within a "special and extraordinary items" classification.

Proprietary Fund Statement of Revenues, Expenses, and Changes in Fund Net Position

6.79 GASB Statement No. 34 paragraph 100 as amended requires the proprietary fund statement of revenues, expenses, and changes in fund net position to

- report revenues by major source.
- report revenues either (*a*) net of discounts and allowances with disclosure of the discount or allowance amount parenthetically on the face of the statement or in a note to the financial statements or (*b*) gross with the related discounts and allowances reported directly beneath the revenue amount.
- distinguish between operating and nonoperating revenues and expenses (as discussed in paragraphs 6.80–.82).
- report revenues from capital contributions and additions to the principal of permanent and term endowments and special and extraordinary items, including those resulting from resource inflows, separately after nonoperating revenues and expenses.

Also see the GASB-established formatting requirements for the proprietary fund statement of revenues, expenses, and changes in fund net position in chapter 2.

6.80 GASB Statement No. 34 paragraph 102 states that governments should establish a definition of operating revenues and expenses that is appropriate to the nature of the activity being reported. It also states that a consideration for defining operating revenues and expenses is how individual transactions are categorized in the fund's statement of cash flows. Those general guidelines tie a proprietary fund's operating revenues and expenses to its main purpose. For example, greens fees and the expenses associated with maintaining the course could be operating revenues and expenses for a golf course, whereas water billings and the expenses associated with providing the water could be operating revenues and expenses for a water utility.[15]

6.81 GASB Statement No. 34 paragraph 102 and footnote 42 indicate that nonoperating revenues generally should include revenues from taxes, certain nonexchange fees and charges, and interest. In addition, nonoperating revenues generally should include revenues from appropriations between primary governments and their component units, contributions, grants, entitlements, and shared revenues for operating purposes or that may be used, at the recipient's discretion, for either operating purposes or capital outlay.[16] However, those types of revenue should be classified as operating revenue when they meet the definition of operating revenue that is appropriate to the nature of the activity as explained in paragraph 6.80. For example, footnote 42 to GASB Statement

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[15] Paragraph 6 of the GASB IG 2015-1 provides additional guidance on reporting cash flows.

[16] Questions 7.72.8 and 7.73.2 of the GASB IG 2015-1 support this classification requirement. Those questions also indicate that revenues that are restricted for the acquisition or construction of capital assets should be classified as capital contributions, reported separately after nonoperating revenues and expenses, not as nonoperating revenues.

No. 34 states that interest revenue and expense transactions should be reported as operating revenue and expense by a proprietary fund established to provide loans to first-time homeowners. Similarly, GASB Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*, paragraph 17 as amended states that cash inflows from operating activities include cash receipts from grants for specific activities that are considered to be operating activities of the grantor government. (A grant arrangement of this type is essentially the same as a contract for services.) If a government classifies certain grants in its statement of cash flows as cash inflows from operating activities, it may be appropriate to classify those same grants as operating revenues.

6.82 The classification of system development fees (see paragraph 6.49) differs among entities. In some instances, fees related to the physical connection to the system are recorded as operating income, and the related costs are expensed. In other cases, amounts assessed that substantially exceed the cost to connect are recorded as capital contributions, reported separately after nonoperating revenues and expenses, or the entire fee is recorded as nonoperating revenue.

6.83 GASB Statement No. 48, as amended, discusses exchanges by governments of interests in their expected cash flows from collecting specific receivables or specific future revenues for immediate cash payments. The statement provides standards for determining whether such exchanges should be classified as sales or as collateralized borrowing transactions. The statement further provides that assets and future revenues transferred in an intra-entity transaction should be reported at their carrying value; that is, they should not be revalued. Paragraph 21 of GASB Statement No. 48 requires certain disclosures related to future revenues pledged or sold. Further, the GASB IG 2015-1 provides questions and answers, questions Z.48.1–Z.48.3, clarifying revenue aspects of implementing GASB Statement No. 48. See the discussion of the provisions of GASB Statement No. 48 in paragraphs 6.57–.61.

Fiduciary Fund Statement of Changes in Fiduciary Net Position

6.84 The fiduciary fund statement of changes in fiduciary net position classifies all resource inflows as additions, not as revenues. Chapter 14 discusses specific provisions for the classifications of additions in the statement of changes in fiduciary net position for defined benefit OPEB plans administered through a trust or equivalent arrangement that meets the specified criteria. Chapter 13 discusses specific provisions for the classifications of additions in the statement of changes in fiduciary net position for defined benefit pension plans that are in the scope of GASB Statement No. 67.

6.85 Agency funds are not reported in the statement of changes in fiduciary net position. However, a combining statement of changes in assets and liabilities for all agency funds should be presented as supplementary information other than required supplementary information, referred to in this guide as *"GASB defined" SI*, when a Comprehensive Annual Financial Report is presented. (Chapters 4 and 16, "Audit Reporting," discuss the auditor's responsibility for and reporting on "GASB defined" SI.)[17]

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[17] This guide uses the term *"GASB defined" SI* to refer to supplementary information other than required supplementary information. See chapter 2, "Financial Reporting," for more information.

Financial Position Statement Classifications

6.86 All receivables should be reported net of estimated uncollectible amounts. Applying the provisions of GASB Statement No. 62 paragraph 33 the allowance for estimated uncollectible receivables should be disclosed in the face of the financial statement (either parenthetically or as a separate line item) or in the notes to the financial statements.

6.87 GASB Statement No. 34, as amended, provides guidance relating to reporting restricted assets, including restricted receivables, in the government-wide and proprietary fund financial statements. See the discussion of those requirements in chapter 2.

Disclosures

6.88 The following are among the disclosures, not noted elsewhere in this chapter, that are required for revenues and receivables:[18]

- The accounting policies used for recognizing revenues (NCGA Statement 1 paragraph 69, and GASB Statement No. 62 paragraphs 90–93)
- A description of the types of transactions included in program revenues in the statement of activities (GASB Statement No. 34 paragraph 115 as amended)
- Nonexchange revenues that are not recognizable because they are not measurable (GASB Statement No. 33 paragraph 11 as amended)
- Various data concerning property taxes as provided in NCGA Interpretation 3 paragraph 11 as amended, including details of the governmental unit's property tax calendar (such as lien dates, levy dates, due dates, and collection dates)
- The length of time used to define *available* for purposes of revenue recognition in the governmental fund financial statements (GASB Statement No. 38, *Certain Financial Statement Note Disclosures*, paragraph 7)
- If, because of unusual circumstances, the facts justify using a period greater than sixty days as the availability period for the modified accrual recognition of property taxes, the period being used and the facts that justify it (NCGA Interpretation 3 paragraph 8 as amended)
- Paragraphs 21–22 of GASB Statement No. 48 require certain disclosures about revenues pledged to collateralize debt and about sales of future revenue streams.
- The policy for defining operating and nonoperating revenues of proprietary funds (GASB Statement No. 34 paragraphs 102 and 115)
- Details about receivables aggregated in the financial statements when those aggregations obscure significant components of the receivables (GASB Statement No. 38 paragraph 13)

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[18] Making disclosures for discretely presented component units is a matter of professional judgment, as discussed in chapter 3, "The Financial Reporting Entity."

- Significant receivable balances not expected to be collected within one year of the financial statement date (GASB Statement No. 38 paragraph 13 as amended)
- The amounts recognized as revenue for on-behalf payments for fringe benefits and salaries and, for those on-behalf payments that are pension plan contributions for which the entity is not legally responsible, the names of the plan and of the entity that makes the contributions (GASB Statement No. 24 paragraph 12)
- The amount of special assessment receivables that are delinquent, if not separately displayed on the face of the financial statements (GASB Statement No. 6 paragraph 20)
- Any significant transactions or other events that are either unusual or infrequent but not within the control of management (GASB Statement No. 34 paragraph 56)
- Tax abatement information as required by GASB Statement No. 77, *Tax Abatement Disclosures*, for the reporting government including brief descriptive information, the gross dollar amount of taxes abated during the period, and other commitments made by a government as part of a tax abatement agreement; for tax abatements entered into by other governments that affect a reporting government's tax revenues including the names of the governments that entered into the agreements, the specific taxes being abated, and the gross dollar amount of taxes abated during the period

Auditing Considerations

6.89 The audit objectives for the revenues, deferred inflows of resources, liabilities (for example, unearned revenue), and receivables of each opinion unit, categorized by financial statement assertion, are as follows:

- *Assertions about classes of transactions and events for the period under audit*:
  - — *Occurrence.* Reported revenues represent amounts relating to the period and pertain to the government.
  - — *Completeness.* The financial statements report all revenues relating to the period.
  - — *Accuracy.* Revenue amounts and other data relating to recorded revenue transactions and events have been recorded appropriately.
  - — *Cutoff.* Revenue transactions and events have been recorded in the correct accounting period.
  - — *Classification.* Revenue transactions and events have been recorded in the proper accounts.
- *Assertions about account balances at the period end*:
  - — *Existence.* Reported receivables represent amounts uncollected as of the end of the period. Reported liabilities and deferred inflows of resources represent amounts received or receivable that have not met the criteria for revenue recognition and are properly classified.

— *Rights and obligations.* The financial statements properly reflect conditions and agreements that affect the government's receivables, liabilities, and deferred inflows of resources as of the end of the period.

— *Completeness.* The financial statements report all receivables, liabilities, and deferred inflows of resources as of the end of the period.

— *Valuation and allocation.* Receivables, liabilities, and deferred inflows of resources are reported at the proper amounts.

- *Assertions about presentation and disclosure*:

  — *Occurrence and rights and obligations.* Disclosed revenue, receivables, liabilities, and deferred inflows of resources transactions have occurred and pertain to the government.

  — *Completeness.* All disclosures relating to revenues, receivables, liabilities, and deferred inflows of resources that should have been included in the financial statements have been included.

  — *Classification and understandability.* Financial information relating to revenues, receivables, liabilities, and deferred inflows of resources is appropriately presented and described and disclosures are clearly expressed.

  — *Accuracy and valuation.* The financial statements properly classify, describe, and disclose revenues, deferred inflows of resources, liabilities, and receivables, including classification in the proper fund and activity. Financial statement presentation and disclosure are made in accordance with GAAP, consistently applied. Financial and other information pertaining to revenues, receivables, liabilities, and deferred inflows of resources is disclosed fairly and at appropriate amounts.

6.90 The auditor might determine the government's various revenue sources by reading legal documents, such as budgets, enabling legislation, and grant agreements; asking appropriate officials about revenue sources; and reviewing the financial statements of the prior period and the draft financial statements or other accounting information for the current period. After identifying the sources and amounts of revenues, the auditor should obtain an understanding of relevant controls over and assess the risks of material misstatement for the processes for billing, accounting for, and collecting major revenue sources. When obtaining an understanding of controls, the auditor should evaluate the design of those controls and determine whether they have been implemented by performing procedures in addition to the inquiry of the entity's personnel.

6.91 The auditor should consider the possibility of the decentralization of the entity's billing, accounting, and collection functions relating to revenues and receivables and, if necessary, perform procedures to identify the various locations that conduct such functions to assess control risk at each location that may materially affect the financial statement assertions. If the government's revenues are collected by another entity, AU-C section 402, *Audit Considerations Relating to an Entity Using a Service Organization* (AICPA, *Professional Standards*), provides requirements and guidance on the factors auditors (referred to as user auditors) should consider when auditing financial statements of an entity that uses a service organization to process certain transactions. As an aside, AT-C section 320, *Reporting on an Examination of Controls at a Service Organization Relevant to User Entities' Internal Control Over Financial Reporting* (AICPA, *Professional Standards*), and the AICPA Guide *Reporting on an Examination of Controls at a Service Organization Relevant to User Entities' Internal Control Over Financial Reporting (SOC 1®)* provide guidance for independent auditors (service auditors) who issue reports on processing of transactions by service organizations for use by other auditors.

6.92 In auditing revenues, receivables, liabilities, and deferred inflows of resources, it usually is more efficient and effective to plan to integrate the audit of receivables with the substantiation of revenues, liabilities, and deferred inflows of resources. Audit procedures should be designed to respond to the assessed risks of material misstatement at the relevant assertion level. Further, the auditor should determine that adequate procedures are performed related to activity and balances in each of those opinion units with material revenues, receivables, liabilities, or deferred inflows of resources. (See the discussion of opinion units in chapter 4.) In the following paragraphs are examples of procedures that address the planning of the audit of revenues, receivables, liabilities, and deferred inflows of resources.

6.93 The auditor should obtain an understanding of the government's internal control over revenues, receivables, liabilities, and deferred inflows of resources.[19] In addition to standard internal control features for those accounts, features that are unique or significant in government may include the following:

- Specific written procedures to authorize and approve abatements, exonerations, and refunds of taxes (including penalties and interest), service charges, and other applicable revenue transactions
- Procedures to ensure that tax, fee, and service rates, exemptions, and discounts are authorized and periodically reviewed by the governing board
- Procedures to compare the detailed lists of current taxpayers; properties subject to property taxes and special assessments; grantors and contributors; service recipients; pension plan contributors; and so forth to (*a*) the prior-period list and to identify and investigate those payers that are not included on the current list and (*b*) corroborating information, such as sales tax vendor files, real estate assessment files, and permit holders, for completeness and validity
- Procedures to ascertain that all adjustments to assessed or taxable property values were properly approved by the appropriate

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[19] AU-C section 240, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*), requires the auditor ordinarily to presume that there is a risk of material misstatement due to fraud relating to revenue recognition and to provide specific documentation if the auditor does not identify improper revenue recognition as a risk of material misstatement due to fraud in a particular circumstance. Appendix A to chapter 4, "General Auditing Considerations," discusses the provisions of AU-C section 240.

board (that is, value adjustment board, and so on), timely recorded in the individual tax records, and accurate adjustments made to the related receivable and revenue accounts

- Procedures to compare actual revenues to budgeted amounts and to investigate significant variances
- Periodic redetermination of property value assessments in accordance with legal provisions, with prompt adjustment of property records
- Procedures to accurately update property records for additions, deletions, transfers, and abatements on a timely basis
- Appropriate legal procedures for liens, tax sales, and foreclosures
- Procedures to total individual tax bills and to compare them to the total tax levy
- Procedures to estimate amounts receivable and revenues from derived tax revenues
- Review of tax returns for accuracy, and supervisory review and approval of large or unusual refund claims
- Conducting audits of tax returns on a scheduled basis
- Procedures to ensure that the entity complies with the eligibility requirements, purpose restrictions, and other compliance requirements of grants, private donations, and trust agreements (See also chapter 8.)
- Procedures to ensure that amounts receivable for fines and fees are properly recorded on a timely basis and evaluated for collectibility
- Procedures to ensure that all utility customers have meters (if applicable), that meters are read, that unusual or illogical readings are investigated, and that the aggregate use indicated by the reading of individual meters is reconcilable to the total use for the system
- Procedures to recognize and classify resource inflows in accordance with GAAP
- Procedures to ensure that enterprise funds that apply the provisions of GASB Statement No. 62 paragraphs 476–500 as amended, comply with the requirements of those standards
- Procedures to ensure that the entity conforms with GASB's recognition and reporting requirements for pass-through grants and on-behalf payments for fringe benefits and salaries
- Procedures to ensure that the entity conforms with GASB's recognition and reporting requirements for sales of receivables and future revenues
- Adequate physical controls over revenues that are collected in cash, such as from public transportation fare-boxes, parking meters, and licenses and permits
- Monitoring of revenues collected for the entity by another government (or another collection agent) for timely receipt and reasonable amounts
- Procedures to ensure that amounts collected by the entity for other governments are segregated and remitted on a timely basis

- Procedures to ensure that all GAAP-required disclosures for revenues and receivables are made in the financial statements

Confirmations

6.94 Many revenues and receivables are susceptible to confirmation. Confirmation of receivables provides evidence about the existence and ownership of a receivable but provides little evidence about collectibility. Collectibility usually is evaluated through the examination of subsequent receipts and historical trends. See AU-C section 505, *External Confirmations* (AICPA, *Professional Standards*), for guidance about the confirmation process.[20] In some cases, audit evidence is obtained more readily through the application of alternative audit procedures.

6.95 The auditor should use external confirmation procedures for accounts receivable, except in specific circumstances as described in paragraph .20 of AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating Audit Evidence Obtained* (AICPA, *Professional Standards*).

6.96 When a receivable balance is composed of a few large balances, which may be the case with receivables arising from intergovernmental revenues and revenues collected by other entities, the auditor may confirm the amounts transmitted to the auditee during the fiscal period as well as the unremitted amounts to be recorded as receivables.

6.97 Often, the confirmation of receivable balances is not effective when the receivable balance is composed of many small balances, which may be the case with receivables arising from property taxes, special assessments, fees, and private donations. In such cases, response rates to properly designed confirmations may be inadequate or unreliable. Based on prior experience, the auditor may consider obtaining audit evidence from other sources. Paragraph .A24 of AU-C section 505 contains guidance on alternative procedures that the auditor may apply to obtain the evidence necessary to reduce audit risk to an acceptably low level. However, paragraph .32 of AU-C section 330 requires the auditor to document the basis for not using external confirmation procedures for receivables when the account balance is material.

Estimates

6.98 Certain receivables, for example, some of those arising from revenues from taxpayer-assessed taxes such as sales and income taxes, are not composed of amounts due from individual taxpayers but rather are estimates of the amount due from the taxpayer group as a whole. (A government's estimation process for certain taxes may have to consider final settlement amounts for refunds as well as additional payments. See paragraph 6.27). In that situation, the auditor should evaluate the reasonableness of the estimation process used to record the receivable. Governments may use various methods to make those

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[20] As provided in paragraphs .A14–.A15 of AU-C section 505, *External Confirmations* (AICPA, *Professional Standards*), responses received electronically (for example, by fax or email) involve risks relating to reliability because proof of origin or identity of the confirming party may be difficult to establish, and alterations may be difficult to detect. The auditor may evaluate whether it is appropriate to address such risks by utilizing a system or process that validates the respondent or by directly contacting the purported sender (for example, by telephone) to validate the identity of the sender of the response and to validate that the information received by the auditor corresponds to what was transmitted by the sender. An electronic confirmation system or process that creates a secure confirmation environment may mitigate the risks of interception or alteration.

estimates, often considering historical information as well as current facts and circumstances (such as tax and withholding rate changes and changes in economic conditions) that affect historical information. Among other factors the auditor might consider are the entity's internal control over the collection of current and delinquent income taxes, the methods it uses for determining population completeness (for example, whether all citizens are filing income tax returns), and its audit and follow-up procedures related to income tax returns filed. However, it usually is not possible to establish conclusively whether all individuals or entities are reporting and paying all the taxes due, or whether the government's enforcement or discovery procedures are effective. To do so would constitute performance auditing and thus go beyond the auditor's responsibilities in relation to an audit of the financial statements. Instead, the auditor would be considering whether reasonable efforts are being made to minimize nonpayment.

6.99 GASB Statement No. 33, as amended, requires recognition of nonexchange transactions in the financial statements unless the transactions are not measurable (reasonably estimable) or are not probable of collection. It also requires recognition of property tax receivables in the period when an enforceable legal claim to the assets arises. If a government's enforceable legal claim to taxable property arises before taxes are levied, the property tax receivable may or may not be reasonably estimable in advance of the levy. In that situation, the auditor should consider evaluating a government's accounting policies and procedures for estimating property tax receivables and for disclosure if the receivables are not recognizable because they are not measurable.

Confidential Records

6.100 In some situations, an auditor may be denied access to certain records underlying a government's revenue amounts (such as income tax returns) because of legal provisions concerning confidentiality. Chapter 4 discusses how an auditor's lack of access to records may constitute a limitation on the scope of the audit if adequate alternative procedures are not available.

Other Auditing Procedures

6.101 In addition to standard audit procedures for revenues, receivables, liabilities, and deferred inflows of resources, other procedures that are unique or significant in government may include the following:

- Reviewing underlying documentation (such as statutes and regulations, governing board minutes, grant contracts and donor letters, contracts to lease or sell capital assets) for support of tax, fine, fee, and service rates and revenue amounts
- Determining whether tax, fee, and service rates are billed consistently and whether rate changes are incorporated into the billing system on a timely basis
- Reviewing adopted rates for compliance of amount or underlying rate-determination methodology with requirements or legal limitations established by regulatory agencies, state statutes, and so on
- Summarizing revenues by source and type and comparing recorded revenue to the current budget and to prior-period actual amounts, and obtaining and evaluating explanations of significant variances

- Reviewing abatements, exonerations, refunds, and similar items for proper approval
- For various revenue types and individual revenue amounts, testing compliance with the legal and contractual provisions that could have a direct and material effect on the determination of financial statement amounts (see paragraph 6.07 and chapter 8)
- Examining substantiation for the tax exemptions of properties and organizations
- Reviewing a sample of taxpayer-assessed tax returns and verifying that the tax liability was calculated in accordance with governing laws and regulations (see paragraph 6.100)
- Considering whether the entity's revenue recognition and classification principles conform with GAAP and are consistently applied
- Evaluating the adequacy of allowances for uncollectible revenues, including evaluating that the entity has filed liens or taken other legally required steps to ensure the collectibility of revenues (see paragraph 6.08)
- Evaluating the adequacy of amounts for probable revenue-related refunds, such as for income or other taxes
- Determining whether revenues are properly recorded for amounts collected by another entity
- Determining whether amounts collected by the entity for other governments are properly segregated and accounted for
- Determining whether the entity's revenue and receivable disclosures conform with GAAP

Chapter 7

Capital Assets

Nature of Transactions

7.01 According to GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, paragraph 19, as amended, capital assets include land, improvements to land, easements, buildings, building improvements, vehicles, machinery, equipment, works of art and historical treasures, infrastructure, and all other tangible or intangible assets that are used in operations and that have initial useful lives extending beyond a single reporting period.[1] Infrastructure assets are long-lived capital assets that normally are stationary in nature and normally can be preserved for a significantly greater number of years than most capital assets. Examples of infrastructure assets are roads, bridges, tunnels, drainage systems, water and sewer systems, dams, and lighting systems. Buildings, except those that are an ancillary part of a network of infrastructure assets, are not considered infrastructure assets. GASB Statement No. 51, *Accounting and Reporting for Intangible Assets*, as amended, establishes standards of accounting and financial reporting for intangible assets. Intangible assets are identifiable (separable or arising from contractual or other legal rights), lack physical substance, are nonfinancial in nature, and have an initial useful life extending beyond a single reporting period. Examples of intangible assets include easements, water rights, timber rights, patents, trademarks, and computer software. In some cases, pollution remediation outlays recognized under GASB Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*, as amended, may be capitalized in government-wide and proprietary fund financial statements, subject to certain limitations (see chapter 8, "Expenses or Expenditures and Liabilities," for further discussion of pollution remediation obligations).

7.02 How capital assets are accounted for in the different basic financial statements depends on the measurement focus used. With certain exceptions discussed in this chapter (for example, using the modified approach),

- capital assets acquired with governmental fund resources are accounted for as capital expenditures and are not capitalized in the governmental fund financial statements. Those capital assets are referred to as *general capital assets*. General capital assets also include capital assets associated with governmental funds that are received through donation, even though not reported as capital expenditures or capitalized in the governmental funds.
- capital assets acquired with proprietary or fiduciary fund resources or donated to those funds are capitalized in those funds and depreciated in those funds over their estimated useful lives.
- in the government-wide financial statements, capital assets, including general capital assets, are capitalized and depreciated over their estimated useful lives.

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[1] GASB *Implementation Guide 2015-1* (GASB IG 2015-1) question 7.9.2 indicates that library books, depending on their nature, may be depreciable capital assets, or works of art or historical treasures (see paragraph 7.23).

This chapter further discusses the accounting and financial reporting for capital assets in paragraphs 7.10–.71. Paragraph 13, "Basic Financial Statements and Management's Discussion and Analysis," and 17, "Other Implementation Guidance," of the GASB *Implementation Guide No. 2015-1* (GASB IG 2015-1) include additional details about defining, accounting for, and reporting on capital assets.

Capital Asset Management

7.03 Governments usually acquire general capital assets with the resources of the general, special revenue, capital projects, and permanent funds. A government's budgeting policies usually affect how the government finances and accounts for general capital asset acquisitions of different sizes and types:

- Governments often budget for and acquire small purchases of personal property, such as vehicles, machinery, equipment, and computer hardware and software through the general fund, special revenue funds, or permanent funds. Those general capital assets normally are financed with, for example, tax revenues, intergovernmental grants, donations from nongovernmental entities, and capital leases.
- Governments often budget for and acquire major capital facilities, such as buildings, bridges, streets, parks, and storm drains, through capital project funds. Those general capital assets normally are financed with, for example, the proceeds of bond issues, special assessment revenues, intergovernmental grants, donations from property developers or other nongovernmental entities, or transfers from other of the government's funds.
- Governments may budget for the acquisition or development of intangible assets through the general fund, special revenue funds, capital project funds, proprietary funds, or fiduciary funds based on, for example, the expected total cost, funding sources, extent of the development project, or expected acquisition or completion date.

7.04 Governments also acquire capital assets for proprietary funds from the same types of sources that finance general capital assets as well as from user fees. Proprietary fund capital assets also may be acquired through governmental fund resources and contributed to the proprietary funds. This often is the method of financing used for newly established proprietary funds.

7.05 Many fiduciary funds do not have capital assets, but some do. For example, public employee retirement systems (PERS) often own the buildings in which they operate, and own the furniture, fixtures, and equipment that they use in operations.

7.06 Governments adopt capitalization threshold policies to establish the per-unit cost that they will use to identify the capital assets they will report in their financial statements. A low capitalization threshold generally will increase the number of items capitalized, whereas a high capitalization threshold has the opposite effect. Typically, a government's capitalization threshold correlates with its size. Management usually sets the capitalization threshold at a level acceptable to its governing board and citizenry, and considering the various compliance requirements that affect capital assets.[2] For example, many grantors require that detailed records be maintained on capital assets acquired with grant moneys that cost in excess of an established amount. A recipient government may decide to coordinate its financial reporting capitalization level with those grant provisions.

7.07 Governments may establish different capitalization thresholds for different types of capital assets. For example, they may establish a higher threshold for infrastructure assets (given their large dollar cost and normally stationary nature) and a lower one for other capital assets such as vehicles, machinery, and equipment. Governments also may establish different capitalization policies for types of assets with low per-unit costs that are held in large quantities (groups), such as computers, classroom furniture, and library books. See GASB IG 2015-1 question 7.9.8.

7.08 Governments often safeguard their capital assets by affixing identification tags (as appropriate), maintaining detailed records, and conducting periodic physical inspections, adjusting the records accordingly. Governments may inspect capital assets that are more susceptible to theft or other misappropriation, such as personal property that is portable and conducive to personal use or to sale, more frequently than capital assets that are not. Many governments extend their capital asset management processes to certain capital assets that do not qualify for capitalization for financial reporting purposes, but that are susceptible to misappropriation, and expensive or otherwise valuable works of art and historical treasures that are not subject to capitalization (see paragraph 7.26).

Compliance Considerations

7.09 Legal and contractual provisions often govern a government's acquisition and disposition of capital assets. For example, capital asset acquisitions generally require budgetary authorization and governing board approval. Also, there often are legal provisions governing procedures for bidding and awarding contracts, and for selling at auction capital assets that are no longer used or for contributing those assets to other governments or to not-for-profit organizations. If funding is derived from a bond issue, there often are debt covenant compliance requirements. If part of the funding is derived from intergovernmental revenues or donations from nongovernmental entities, there may be compliance requirements that relate not only to the acquisition and disposition of capital assets but also to the maintenance of and recordkeeping for the assets. Although a government should be concerned with all compliance requirements, generally accepted auditing standards focus the auditor's concern on those compliance requirements that could have a direct and material effect on the determination of financial statement amounts. (See the further discussion of the auditor's responsibility in this regard in chapter 4, "General Auditing Considerations," of this guide.)

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[2] GASB IG 2015-1 question 7.22.17 indicates that a change to an entity's capitalization threshold is not reported as an accounting principles change, which according to paragraphs 76–82 of GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, as amended, would require retroactive restatement of beginning balances.

Accounting and Financial Reporting Considerations

7.10 Paragraphs 7.13–.34 discuss the general accounting and financial statement presentation standards for capital assets depending on the financial statements involved. (Tables 7-1 and 7-2 in paragraphs 7.11–.12 summarize certain of those standards.) Paragraphs 7.35–.70 discuss specific accounting and financial reporting standards for capital leases, capital asset impairment, the modified approach for infrastructure assets, the specified conditions approach for internally generated intangible assets, interfund movements of capital assets, capital assets used in landfills, capital assets used in pollution remediation activities, and capital assets related to service concession arrangements. Paragraphs 7.71–.74 discuss requirements for (*a*) disclosures about capital assets in the notes to the financial statements and (*b*) the management's discussion and analysis.

7.11 Table 7-1 provides an overview of the accounting in the government-wide statement of activities, the proprietary fund statement of revenues, expenses, and changes in net position, and the statement of changes in fiduciary net position[3] for the use of capital assets. Those activity statements use the economic resources measurement focus and accrual basis of accounting. The governmental funds, which use the current financial resources measurement focus and modified accrual basis of accounting, do not report the use of capital assets. Instead, capital expenditures are reported in the period the fund liability is incurred.

Table 7-1

Accounting for the Use of Capital Assets

Type of Capital Asset	*Accounting*
Inexhaustible [a] capital assets, such as land and certain land improvements and certain works of art, historical treasures, intangible assets with an indefinite useful life,[b] and similar assets,[c] as well as construction in progress[d]	No depreciation or amortization of the asset is recorded
Infrastructure assets:	
Eligible infrastructure assets[e]	Depreciation method or the modified approach
Other than eligible infrastructure assets	Depreciation method

[3] This presentation of capital assets applies to all fiduciary funds except agency funds. Agency funds should not be reported in the statement of changes in fiduciary net position; thus, there is no presentation of capital assets.

Accounting for the Use of Capital Assets—*continued*

Type of Capital Asset	*Accounting*
Other exhaustible capital assets, such as buildings, building improvements, vehicles, machinery, equipment, and certain works of art, historical treasures, intangibles, and similar assets	Depreciation or amortization method

[a] An inexhaustible capital asset is one whose economic benefit or service potential is used up so slowly that its estimated useful life is extraordinarily long.

[b] An indefinite useful life intangible asset has no legal, contractual, regulatory, technological, or other factors that limit its useful life.

[c] GASB Statement No. 34 paragraph 27 establishes the criteria under which certain works of art, historical treasures, and similar assets are not required to be capitalized, although capitalization is encouraged. See paragraph 7.26.

[d] This provision comes from question 7.11.1 of paragraph 13 of the GASB IG 2015-1 rather than from GASB Statement No. 34, as amended.

[e] Eligible infrastructure assets are infrastructure assets that are part of a network or subsystem of a network, as discussed in paragraph 7.19.

7.12 Table 7-2 provides an overview of capital asset reporting for different situations.

Table 7-2

Capital Asset Reporting

Activity	*Government-wide Financial Statements*	*Governmental Fund Financial Statements*	*Proprietary Fund Financial Statements*	*Fiduciary Fund Financial Statements*[a]
Capital assets purchased or received through donation (except noncapitalized works of art, historical treasures, and similar assets[b, c])	• Capitalize assets • Report donation as program revenue, general revenue or contribution to term or permanent endowment	• Report assets purchased as an expenditure • Reporting donated assets as assets or as a financial resource inflow or outflow may depend on whether the assets are held for use (See paragraph 7.32.)	• Capitalize assets • Report donation as capital contribution or addition to term or permanent endowment	• Capitalize assets • Report donation as addition

(continued)

Capital Asset Reporting—*continued*

Activity	*Government-wide Financial Statements*	*Governmental Fund Financial Statements*	*Proprietary Fund Financial Statements*	*Fiduciary Fund Financial Statements*
Noncapitalized works of art, historical treasures, and similar assets[b] purchased or received through donation	• Report assets purchased and received through donation as an expense • Report donation as program revenue, general revenue or contribution to term or permanent endowment	• Report assets purchased as an expenditure • Reporting donated assets as assets or as a financial resource inflow or outflow may depend on whether the assets are held for use (See paragraph 7.32.)	• Report assets purchased and received through donation as an expense • Report donations as capital contribution or addition to term or permanent endowment	• Report assets purchased and received through donation as a deduction • Report donation as addition
Capital assets accounted for using the depreciation[e, f] method (Table 7-1 in paragraph 7.11 identifies these assets.)				
Use of exhaustible capital assets or intangible assets with definite useful lives	• Charge depreciation expense and increase accumulated depreciation[e]	• Not applicable	• Charge depreciation expense and increase accumulated depreciation[e, f]	• Charge depreciation deduction and increase accumulated depreciation[e, f]
Outlays that extend the estimated useful lives of the assets (preservation costs) or improve their efficiency (improvements) or capacity (additions)[c, d, e, f]	• Capitalize and depreciate	• Report as expenditures	• Capitalize and depreciate	• Capitalize and depreciate
Outlays for repairs and maintenance[c, d]	• Report as expenses	• Report as expenditures	• Report as expenses	• Report as deductions
Infrastructure capital assets accounted for using the modified approach (Table 7-1 in paragraph 7.11 identifies these assets.)				

Capital Asset Reporting—*continued*

Activity	*Government-wide Financial Statements*	*Governmental Fund Financial Statements*	*Proprietary Fund Financial Statements*	*Fiduciary Fund Financial Statements*
Use of infrastructure capital assets	• No charge for depreciation	• Not applicable	• No charge for depreciation	• No charge for depreciation
Outlays that improve the assets' efficiency (improvements) or capacity (additions)	• Capitalize	• Report as expenditures	• Capitalize	• Capitalize
Outlays that extend the estimated useful lives of the assets (preservation costs) and outlays for repairs and maintenance	• Report as expenses	• Report as expenditures	• Report as expenses	• Report as deductions
Sales and other dispositions (except impairment) of capital assets (See chapter 6, "Revenues and Receivables.")	• Remove the assets' cost and any accumulated depreciation • Report gain or loss on sale as general revenue or general government-type expenses[c, d, e, f]	• Report proceeds as other financing source[d, e]	• Remove the assets' cost and any accumulated depreciation • Report gain or loss on sale as revenue or expense (usually nonoperating)[d, e]	• Remove the assets' cost and any accumulated depreciation • Report gain or loss on sale as an addition (deduction)
Capital asset impairment	• Reduce the net carrying value of the asset for the amount of the loss • Report loss (or gain) as a program expense, special item, or extraordinary item, netted with any associated insurance recovery that is realized or realizable in the same year	• No recognition of impairment loss • Report any insurance recovery as an other financing source or extraordinary item • Report restoration or replacement of the impaired asset as a separate transaction from any insurance recovery	• Reduce the net carrying value of the asset for the amount of the loss • Report loss (or gain) as an operating expense, special item, or extraordinary item, netted with any associated insurance recovery that is realized or realizable in the same year	• Reduce the net carrying value of the asset for the amount of the loss • Report loss (or gain) as a deduction, netted with any associated insurance recovery that is realized or realizable in the same year

(continued)

Capital Asset Reporting—*continued*

Activity	*Government-wide Financial Statements*	*Governmental Fund Financial Statements*	*Proprietary Fund Financial Statements*	*Fiduciary Fund Financial Statements*
	• Report restoration or replacement of the impaired asset as a separate transaction from the impairment loss (or gain) and any associated insurance recovery		• Report restoration or replacement of the impaired asset as a separate transaction from the impairment loss (or gain) and any associated insurance recovery	• Report restoration or replacement of the impaired asset as a separate transaction from the impairment loss (or gain) and any associated insurance recovery

[a] This presentation does not apply to agency funds because the statement of changes in fiduciary net position does not include agency funds.

[b] GASB Statement No. 34 paragraph 27 establishes the criteria under which certain works of art, historical treasures, and similar assets are not required to be capitalized, although capitalization is encouraged. (See paragraph 7.26.)

[c] Capital assets that underlie a service concession arrangement should be treated like any other capital asset of the government.

[d] These provisions come from paragraph 13 of the GASB IG 2015-1 rather than from GASB Statement No. 34, as amended.

[e] The gain, loss, or proceeds also could qualify for reporting as a special item.

[f] GASB Statement No. 51 amends GASB Statement No. 34 to expand the term *depreciation* to include amortization of intangible assets.

Accounting and Financial Statement Presentation—Government-Wide Financial Statements

7.13 Capital assets are capitalized in a government's government-wide financial statements, except for certain general infrastructure assets as discussed in paragraphs 7.21–.22, certain assets attributable to landfill closures and certain works of art, historical treasures, and similar assets as discussed in paragraph 7.26. (*General infrastructure assets* are infrastructure assets acquired with governmental funds resources or otherwise associated with the governmental funds.) When capitalized, capital assets should be reported at actual or estimated historical cost or, if donated, at acquisition value.[4] Historical cost should include ancillary charges necessary to place the asset into its intended location and condition for use. Ancillary charges include costs that are directly attributable to asset acquisition—such as freight and transportation charges, site preparation costs, and professional fees. The amount capitalized for donated capital assets also should include ancillary charges, if any.

[4] Donations of capital assets are reported as resource inflows in the government-wide financial statements. See table 7-2 in paragraph 7.12 and chapter 6, "Revenues and Receivables." GASB IG 2015-1 question 7.34.7 discusses the classification of donations of infrastructure assets as program or general revenues.

The cost of capital assets reported in business-type activities, which are capital assets reported in enterprise funds, should include capitalized interest. Interest capitalization is discussed in paragraphs 5–22 of GASB Statement No. 62 and, as further discussed in question 7.10.3 of the GASB IG 2015-1 states if an enterprise fund has any type of debt, the portion of the interest expense that theoretically could have been avoided generally should be capitalized as part of the cost of assets constructed during the period. Paragraphs 19–20 of GASB Statement No. 62 provide in part that the interest cost of acquiring assets with the proceeds of tax-exempt borrowings should be offset by the interest earned on the temporary investment of those proceeds if those funds are externally restricted to finance the acquisition of specified qualifying assets or to service the related debt. The cost of general capital assets should not include capitalized interest.

7.14 Often, outlays relating to capital assets are made after the assets are placed in service. GASB Statement No. 34, as amended, does not establish standards for when those costs should be capitalized or expensed, except as discussed in paragraph 7.45 relating to the modified approach. Under GASB Statement No. 51, as amended, outlays related to internally generated computer software are not capitalized after the software is substantially complete and operational (see paragraph 7.58). However, GASB Statement No. 51, as amended, does allow for the capitalization of modifications of computer software that is already in service in certain circumstances (see paragraph 7.59). For capital assets that are depreciated, as provided in GASB IG 2015-1 question 7.17.1, expenditures that extend the useful lives of capital assets beyond their initial estimated useful lives (preservation costs) or improve their efficiency (improvements) or capacity (additions) are capitalized, whereas expenditures for repairs and maintenance are expensed.

7.15 Infrastructure assets, like most capital assets, should be reported by the government that owns the asset.[5] In some situations, ownership of infrastructure assets may be supported by legal documentation, such as deeds or titles conveyed when the government acquires the assets. In other situations, ownership may be supported by legal or contractual provisions that stipulate ownership under certain conditions. However, in still other situations, ownership may be unclear.

7.16 If ownership is unclear, footnote 67 to GASB Statement No. 34 paragraph 154 requires a government that has the primary responsibility for managing an infrastructure asset to report the asset in its financial statements, even if it has contracted with a third party to maintain the asset. (In addition, GASB Statement No. 6, *Accounting and Financial Reporting for Special Assessments*, as amended, requires that capital assets constructed or acquired with capital improvement special assessment debt, which often are infrastructure assets, be reported as the government's capital assets.) The question of ownership and thus the issue of which entity should report particular infrastructure assets can arise in situations in which those assets have been financed by a cooperative endeavor, intergovernmental revenues, or private sources. For example, a developer may convey the continuing management of a subdivision's streets and utilities to a government. If ownership of those streets and utilities

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[5] In the GASB IG 2015-1, questions 7.12.14–7.12.15 clarify that ownership, if clear, determines which entity should report infrastructure assets, and questions 7.9.6 and 7.12.2 discuss manifestations of ownership.

also has been conveyed to the government or if ownership is unclear, the government should report that infrastructure as its assets. However, if ownership of those assets remains with the developer or with the property owners in the subdivision and the government simply maintains the assets, the government should not report the infrastructure as its assets.

7.17 The location of infrastructure assets within a government's jurisdiction does not by itself determine what entity should report particular infrastructure assets. Roads within a county may be owned or managed by a city, the state, or a special district. Roads that are physically located within a county are not county assets, unless the county owns the roads or (if ownership is unclear) has primary responsibility for managing the roads.

7.18 On occasion, a government may transfer ownership of infrastructure assets to another government. In that situation, the transferor government should report the removal of the net book value of those infrastructure assets from its financial statements using the provisions of GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, as amended, and GASB Statement No. 34, as amended. The transferee government also should recognize and report the receipt of the donated infrastructure assets using the provisions of GASB Statement Nos. 33 and 34. That transaction may involve the reporting of special or extraordinary items.

7.19 For purposes of applying its capital assets standards, GASB Statement No. 34, as amended, defines a *network of assets* and a *subsystem of a network of assets*. A network of assets is all assets that provide a particular type of service for a government; a network of infrastructure assets may be only one infrastructure asset that is composed of many components. For example, a network of infrastructure assets may be a dam composed of a concrete dam, a concrete spillway, and a series of locks. A subsystem of a network of assets is all assets that make up a similar portion or segment of a network of assets. For example, all the roads of a government could be considered a network of infrastructure assets. Interstate highways, state highways, and rural roads each could be considered a subsystem of that network.

7.20 GASB Statement No. 34, as amended, requires capital assets, including intangible assets, that are being or that have been depreciated to be reported net of accumulated depreciation in the statement of net position. (Accumulated depreciation may be reported on the face of the statement or disclosed in the notes.) Capital assets that are not being depreciated (see paragraph 7.27) should be reported separately if the government has a significant amount of those assets. (GASB IG 2015-1 question 7.13.5 provides that governments should report fully depreciated capital assets that have not been disposed of by reporting both historical cost and accumulated depreciation for the assets.) Capital assets also may be reported in greater detail, such as by major class of asset (for example, intangibles, infrastructure, buildings and improvements, vehicles, machinery, and equipment).

Retroactive Application of Standards for General Infrastructure Assets and Intangible Assets

7.21 GASB Statement No. 34, as amended, exempted smaller governments from retroactively applying its capitalization requirements to general infrastructure assets. That is, governments with total annual revenues of less than $10 million in the first fiscal year ending after June 15, 1999 (also referred to as phase 3 governments), were not required to retroactively apply the capitalization requirements to general infrastructure assets owned as of the date they implemented the statement.[6] Other governments were required to retroactively apply the capitalization requirements only to *major* general infrastructure assets (as defined in paragraph 7.22) acquired in fiscal years ending after June 30, 1980, or that were significantly reconstructed or improved during that multiyear period.

7.22 GASB Statement No. 34 paragraph 156 states that the determination of major general infrastructure assets should be at the network or subsystem level (see paragraph 7.19) and should be based on the following criteria:

- The cost or estimated cost of the subsystem is expected to be at least 5 percent of the total cost of all general capital assets reported in the first fiscal year ending after June 15, 1999.
- The cost or estimated cost of the network is expected to be at least 10 percent of the total cost of all general capital assets reported in the first fiscal year ending after June 15, 1999.

GASB IG 2015-1 question 7.106.2 explains that those percentage calculations should be based on total reported cost of all general capital assets before any previously unrecorded infrastructure has been capitalized.

7.23 With regard to intangible assets, governments that were classified as phase 1 or phase 2 governments for the purpose of implementing GASB Statement No. 34, retroactive reporting is required except for (*a*) those intangible assets considered to have indefinite useful lives as of the effective date of GASB Statement No. 51 and (*b*) those that would be considered internally generated. If determining actual historical costs for these intangible assets is not practical due to the lack of sufficient records, these governments should report the historical cost for the intangible assets that were acquired in fiscal years ending after June 30, 1980. For governments that were classified as phase 3 governments (see paragraph 7.21), retroactive reporting of intangible assets is encouraged but not required.

7.24 Retroactive reporting of intangible assets considered to have indefinite useful lives as of the effective date of GASB Statement No. 51 is not required but is permitted. However, only intangible assets with indefinite useful lives as of the effective date of GASB Statement No. 51 that were previously subjected to amortization should be reported retroactively. Accumulated amortization related to these assets reported prior to the implementation of the statement should be restated to reflect the fact that these assets are not to be amortized.

7.25 Retroactive reporting is only permitted for internally generated intangible assets (including those in development as of the effective date of GASB Statement No. 51) for which the specified conditions approach (see paragraphs 7.57 and 7.59) can be effectively applied to determine the appropriate historical cost as of the effective date of the statement.

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[6] GASB IG 2015-1 questions 7.85.5 and 7.104.15 discuss the disclosures that should be made by smaller governments that do not retroactively report some or all of their general infrastructure assets. In addition, question 7.104.16 explains that GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments* does not impose a time restriction on when those smaller governments may choose to retroactively report those assets.

Works of Art, Historical Treasures, and Similar Assets

7.26 Unless a government meets all of the following conditions, it should capitalize collections of and additions to collections of works of art, historical treasures, and similar assets. Governments are encouraged, but not required, to capitalize those collections that meet all of the following conditions:

a. Held for public exhibition, education, or research in furtherance of public service, rather than financial gain

b. Protected, kept unencumbered, cared for, and preserved

c. Subject to an organizational policy that requires the proceeds from sales of collection items to be used to acquire other items for collections

Footnote 22 to GASB Statement No. 34 paragraph 27 requires collections already capitalized at June 30, 1999, to remain capitalized and all additions to those collections to be capitalized, even if they meet the conditions for exemption from capitalization.

Depreciation Expense

7.27 GASB Statement No. 34 paragraphs 21, as amended, and 22 require the net cost recorded for capital assets (historical cost less estimated salvage [or residual] value)[7] to be depreciated and reported in the statement of activities over their estimated useful lives in a systematic and rational manner, unless they are (*a*) inexhaustible, (*b*) infrastructure assets using the modified approach discussed in paragraphs 7.45–.51, or (*c*) intangible assets with indefinite useful lives (construction in progress also would not be depreciated; see GASB IG 2015-1, question 7.11.1). GASB IG 2015-1 questions 7.9.3 and 7.21.9 define an *inexhaustible capital asset* as one whose economic benefit or service potential is used up so slowly that its estimated useful life is extraordinarily long and gives the examples of land and certain land improvements and works of art, historical treasures, and similar assets whose useful lives are not diminished by display or educational or research applications. GASB IG 2015-1 questions 7.11.4 and 7.13.4 state that inexhaustible land improvements may include, for example, excavation, fill, and grading, and exhaustible land improvements may include, for example, parking lots and fences. GASB Statement No. 51, as amended, states that the useful life of an intangible asset arising from contractual or other legal rights should not exceed the period to which the service capacity of the asset is limited by such provisions. Renewal periods related to these rights may be considered in determining the useful life if there is evidence the government will seek, and be able to achieve, renewal and that any anticipated outlays to be incurred in the renewal process are nominal relative to the expected service level capacity obtained through the renewal.

7.28 GASB Statement No. 34 paragraph 161 permits governments to use any established depreciation method. Depreciation expense may be calculated for (*a*) a class of assets, (*b*) groups of assets of the same class, (*c*) a network of assets, (*d*) a subsystem of a network, or (*e*) individual assets. (See the definitions of networks of assets and subsystems of networks at paragraph 7.19.) In estimating useful life to calculate depreciation expense, a government should

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[7] GASB IG 2015-1 question 7.13.3 states that residual value is the estimated fair value of a capital asset, infrastructure or otherwise, remaining at the conclusion of its estimated useful life. It also states that, in most cases, it is probable that many infrastructure assets will have no residual value, given the cost of demolition or removal.

consider an asset's present condition and how long it is expected to meet service demands.[8] Governments also may use composite and group methods to calculate depreciation expense, as described in GASB Statement No. 34 paragraphs 163–166. A composite or group depreciation rate should be recalculated if the composition of the assets in the composite or group or their estimated average useful lives change significantly (for example, as assets are acquired or disposed of). The GASB IG 2015-1 explains composite depreciation methods in questions 7.15.1–7.15.4.

7.29 The general standards for the classification of expenses in the government-wide statement of activities are discussed in chapters 2, "Financial Reporting," and 8. Except for depreciation expense for general infrastructure assets (see paragraph 7.27), depreciation expense should be included as a direct expense of functions in the statement of activities for capital assets that can specifically be identified with a function and for a ratable portion of the depreciation expense for "shared" capital assets (for example, a facility that houses the police department, the building inspection office, and the water utility office). Depreciation expense for capital assets that essentially serve all functions is not required to be included in the direct expenses of the various functions.[9] That depreciation expense may be included as a separate line in the statement of activities or as part of the general government function (and subsequently may be allocated to other functions as discussed in chapter 8). If a government uses a separate line in the statement of activities to report unallocated depreciation expense, it should clearly indicate on the face of the statement (for example, through the labeling of the line item) that it excludes direct depreciation expenses of the various programs.

7.30 Depreciation expense for general infrastructure assets should not be allocated to the various functions. Instead, it should be reported as (*a*) a direct expense of the function (such as, public works or transportation) that the government normally associates with capital outlays for, and maintenance of, infrastructure assets or (*b*) a separate line item.

Accounting and Financial Statement Presentation—Governmental Funds

7.31 The governmental funds report the costs associated with acquiring general capital assets as expenditures. (Chapter 8 discusses the classification of expenditures in the governmental funds statement of revenues, expenditures, and changes in fund balances.) General capital assets are not capitalized or depreciated in the governmental fund financial statements. However, subject to the government's capitalization policies, general capital assets are recorded in the government's accounting records so that they can be reported in the

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[8] Paragraph 13, "Basic Financial Statements and Management's Discussion and Analysis," of the GASB IG 2015-1 provides additional guidance on calculating estimated useful lives. For example, GASB IG 2015-1 question 7.14.1 states that in determining an asset's estimated useful life, the government also should consider how the asset is used, its construction type, the maintenance policy, and how long it is expected to meet technology demands. In addition, GASB IG 2015-1 question 7.14.2 states that schedules of depreciable lives established by federal or state tax regulations generally are not intended to represent useful lives.

[9] Determining the point at which an asset serves essentially all functions involves professional judgment. GASB IG 2015-1 question 7.29.1 states that an asset that serves essentially all functions may be one that serves many functions, thus decreasing the ease, practicality, and usefulness of allocating depreciation among functions.

government-wide financial statements. (See the requirements for capitalizing capital assets in the government-wide financial statements in paragraph 7.13.)

7.32 Because of the current financial resources measurement focus, GASB standards do not require governments to report general capital assets acquired through donation as revenues (or other financial resource inflows) or expenditures in the governmental funds unless the donated assets are being held for sale.

Accounting and Financial Statement Presentation—Proprietary Funds

7.33 General accounting standards for proprietary fund capital assets, including infrastructure assets, are the same as those described for the government-wide financial statements in paragraphs 7.13–.20 and 7.23–.25. GASB standards do not establish specific display requirements relating to proprietary fund capital assets. (The provisions discussed in paragraphs 7.21–.22 concerning retroactive application of standards for general infrastructure assets do not apply to infrastructure assets associated with proprietary funds.)

Accounting and Financial Statement Presentation—Fiduciary Funds

Update 7-1 *Fiduciary Activities*

GASB Statement No. 84, *Fiduciary Activities*, establishes criteria for identifying and reporting fiduciary activities. The criteria for identification of fiduciary activities primarily focuses on (*a*) whether a government controls the assets of the fiduciary activity and (*b*) the beneficiaries with whom a fiduciary relationship exists.

Governments with activities meeting the criteria will present a statement of fiduciary net position and a statement of changes in fiduciary net position, with certain exceptions.

There are four classifications of fiduciary funds described in GASB Statement No. 84: (1) pension (and other employee benefit) trust funds, (2) investment trust funds, (3) private-purpose trust funds, and (4) custodial funds. Custodial funds should report fiduciary activities that are not held in a trust or equivalent arrangement that meets specific criteria. Note that agency funds will no longer be reported upon application of this statement.

The statement was issued in January 2017 and is effective for fiscal years beginning after December 15, 2018. Earlier application is encouraged.

Upon its effective date, GASB Statement No. 84 will affect the guidance in this chapter.

The full text of the statement is available on GASB's website at www.gasb.org.

7.34 General accounting standards for fiduciary fund capital assets, including infrastructure assets, are the same as those described for the government-wide financial statements in paragraphs 7.13–.20 and 7.26–.28. GASB standards do not establish specific display requirements relating to fiduciary fund capital assets. (The provisions discussed in paragraphs 7.21–.25 concerning retroactive application of standards for general infrastructure and intangible assets do not apply to infrastructure assets associated with fiduciary funds.) Certain operations, such as PERS and endowments, may own land and buildings as investments, not as capital assets used in operations. PERS account for those assets using the standards for investments as indicated in GASB Statement Nos. 67 and 72, whereas endowments account for such assets under GASB Statement No. 52, *Land and Other Real Estate Held as Investments by Endowments*. (See the accounting and financial reporting for investments in chapter 5, "Investments, Certain Equity Interests, and Derivatives.")

Capital Leases

7.35 Many governments enter into lease purchase agreements, installment purchase contracts, certificates of participation, or other forms of capital asset financing agreements (collectively termed *lease agreements*). The accounting and financial reporting for lease agreements is described in paragraphs 211–271 of GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, as amended, which require that leases that transfer substantially all of the rights and benefits of ownership to the lessee (and that meet specific criteria) be accounted for as an acquisition of an asset and the incurrence of an obligation by the lessee (a capital lease). All other leases should be accounted for as operating leases. Accordingly, a lease is classified as either a capital lease or an operating lease. This chapter discusses lessee accounting and financial reporting for capital leases; chapter 8 discusses lessee accounting and financial reporting for operating leases. Chapter 12, "Special-Purpose and State Governments," in the section on financing authorities, discusses specialized standards for leases between a primary government and a public authority that is either part of the primary government or a component unit. (Chapter 6, "Revenues and Receivables," discusses lessor accounting.)

7.36 If a lease agreement is a capital lease following the guidance in the previous paragraph, the leased asset generally should be capitalized. Capital lease accounting in the government-wide, proprietary fund, and fiduciary fund financial statements should follow GASB Statement No. 62 without modification. Generally, the amount capitalized, as determined at the beginning of the term of the lease, is the lesser of the present value of the rental and other minimum lease payments or the fair value of the leased property, excluding actual or estimated payments for executory costs to be paid by the lessor, together with any profit thereon. The leased property is amortized in accordance with the government's normal depreciation policy for owned assets of the same type. The amortization period is restricted to the lease term, rather than the useful life of the asset, unless the lease provides for transfer of title or includes a bargain purchase option. GASB Statement No. 62 also contains additional details concerning lessee accounting for capital leases.

7.37 National Council on Governmental Accounting (NCGA) Statement 5, *Accounting and Financial Reporting Principles for Lease Agreements of State and Local Governments*, as amended, states that capital leases are reported differently in the governmental funds than in the financial statements of other funds and than in the government-wide financial statements. Reporting is different because of the current financial resources measurement focus and modified accrual basis of accounting used in the governmental funds. The aggregate purchase liability should be reported as an expenditure and an other financing source in the governmental fund that acquired the asset through a capital lease. (General capital assets and general long-term liabilities arising from governmental fund capital leases should be reported only in the governmental activities column in the government-wide statement of net position.) NCGA Statement 5, as amended, requires payments under the lease agreement to be recorded in the same manner as other debt service payments. (Chapter 8 discusses the recognition of expenditures for debt service payments.)

7.38 Some lease agreements may contain a fiscal funding or cancellation clause to avoid classification as legal debt for debt limit or voter referendum purposes. Such a clause provides that, although the government will use its best effort to make the lease payments, it may terminate the lease without penalty if its appropriating body does not allocate the necessary moneys for lease payments in future adopted budgets. That clause gives the financing the character of a one-year annually renewable lease and is not considered legal debt by a number of governments under their state laws. However, NCGA Statement 5 paragraph 20 indicates that the potential for cancellation of most government lease agreements is remote, and paragraph 21 states that fiscal funding or cancellation clauses should not prohibit lease agreements from being capitalized. Therefore, if a lease agreement meets all other capitalization criteria except for the noncancelable criterion, the likelihood of the lease being canceled should be evaluated. If the possibility of cancellation is remote, the lease should be capitalized by recording the leased asset and the lease obligation (liability).

Capital Asset Impairment

7.39 GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*, as amended, establishes accounting and financial reporting standards for the impairment of capital assets. *Asset impairment* is a significant, unexpected decline in the service utility of a capital asset. *The service utility of a capital asset* is the usable capacity that at acquisition was expected to be used to provide service. The events or changes in circumstances that lead to impairments are not considered normal and ordinary—at the time the capital asset was acquired, the government did not expect the event or change in circumstance to occur during the useful life of the capital asset. The expiration of a patent or trademark is not considered an impairment of the related intangible asset because renewal periods are considered in determining the useful life of an intangible asset (see paragraph 7.27). Determining whether a capital asset is impaired involves a two-step process of (*a*) identifying potential impairments (see paragraph 7.40) and (*b*) testing for impairment (see paragraph 7.41).

7.40 The events or changes in circumstances affecting a capital asset that may indicate impairment are prominent—that is, conspicuous or known to the government. GASB Statement No. 42 paragraph 9, as amended, more completely describes the following five common indicators of impairment:

- Evidence of physical damage that is of such a level that restoration efforts are needed to restore service utility
- Enactment or approval of laws or regulations or other changes in environmental factors
- Technological development or evidence of obsolescence
- A change in the manner or expected duration of use of a capital asset
- Construction stoppage or development stoppage

A change in demand for the services of a capital asset is not considered a separate indicator of impairment. However, one of the indicators listed previously may cause or be associated with changes in demand, and governments should test capital assets in those circumstances for impairment. When factors or conditions, or both, indicate an indefinite life intangible asset may no longer have an indefinite life, the intangible asset should be tested for impairment (change in the expected duration of use). Following the recognition of any impairment loss, any carrying value of the intangible asset should be amortized over any remaining estimated useful life of the asset in subsequent reporting periods.

7.41 A government should test a capital asset, with an indicator of impairment, for impairment by determining whether (*a*) the magnitude of the decline in service utility is significant and (*b*) the decline in service utility is unexpected. A decline in service utility is significant when the expenses associated with continued operation and maintenance (including depreciation) or costs associated with restoration of the capital asset are significant in relationship to the current service utility. The decline in service utility is unexpected when the restoration cost or other impairment circumstance is not a part of the normal life cycle of the capital asset. If the asset meets both impairment tests, a government should measure the amount of the impairment—the portion of carrying value of the asset that should be written off—as discussed in paragraphs 7.41–.44. However, if the capital asset is impaired through enactment or approval of laws or regulations or other changes in environmental factors, change in technology or obsolescence, change in manner or duration of use, or construction or development stoppage and evidence demonstrates that the impairment will be temporary, a government should not write down the capital asset. (GASB IG 2015-1 question Z.42.2 indicates that physical damage to capital assets accounted for using the modified approach is considered to be temporary.) Further, if an event or circumstance indicates that a capital asset may be impaired, but the test of impairment determines that impairment has not occurred, a government should reevaluate and change, if necessary, the estimates of remaining useful life and salvage value used in depreciation calculations.

7.42 If a government will continue to use the impaired asset, it should measure the amount of impairment by one of three methods that most appropriately reflects the decline in service utility of the asset. The three methods, which paragraph 12 of GASB Statement No. 42 more completely describes and the nonauthoritative appendix C of GASB Statement No. 42 illustrates, are

- the restoration cost approach, which derives the amount of the impairment from the estimated costs to restore the utility of the capital asset.
- the service units approach, which isolates the historical cost of the service utility of the capital asset that cannot be used due to the impairment event or change in circumstances.
- the deflated depreciated replacement cost approach, which replicates the historical cost of the service produced.

The restoration cost approach generally should be used to measure impairments resulting from physical damage. The service units approach generally should be used to measure impairments resulting from enactment or approval of laws or regulations or other changes in environmental factors or from technological development or obsolescence. The deflated depreciated replacement cost or the service units approach generally should be used to measure impairments identified from a change in manner or duration of use.

7.43 For impaired capital assets that a government will not continue to use and for capital assets impaired from construction or development stoppage, the government should report the assets at the lower of carrying value or fair value.

7.44 As further discussed in GASB Statement No. 42 paragraph 17, as amended, a government should report an impairment loss (or gain, which may result from an associated insurance recovery that is realized or realizable in the same year) in the statement of activities and statement of revenues, expenses, and changes in fund net position, if appropriate, as a program or operating expense, special item, or extraordinary item using the guidance in GASB Statement No. 34, as amended, and paragraphs 45–49 in GASB Statement No. 62. (Chapter 8, in the section on claims and judgments, further discusses insurance recoveries.) GASB IG 2015-1 question Z.42.11 states that the guidance for insurance recoveries in GASB Statement No. 42 paragraphs 21–22 applies equally to insurance recoveries from any policy, whether or not the policyholder is the government. GASB IG 2015-1 question Z.42.12 indicates that a net impairment loss can be reflected in the capital asset accounts either by increasing the accumulated depreciation account for the impaired asset by the amount of a loss; or, the capital asset historical cost account and related accumulated depreciation can be decreased proportionately so that the net decrease equals the amount of the loss. Governments should not reverse impairment losses in future years, even if the events or circumstances causing the impairment have changed. GASB Statement No. 42, as amended, illustrates that capitalizing restoration costs is not a reversal of impairment. Additionally, pollution remediation performed to restore a pollution-caused decline in the service utility of a capital asset that was recognized as an asset impairment should be capitalized, subject to certain limits, under GASB Statement No. 49, as amended.

Modified Approach for Infrastructure Assets

7.45 GASB Statement No. 34, as amended, introduces an alternative to the depreciation of infrastructure assets that are part of a network or subsystem of a network (eligible infrastructure assets) that it terms the *modified approach*. Because the modified approach is an alternative to depreciation, it can be used for eligible infrastructure assets in the government-wide and proprietary and fiduciary fund financial statements. The modified approach is not used in the governmental fund financial statements because those financial statements do not record capital assets or depreciation. The modified approach may not be applied to an individual infrastructure asset unless that asset constitutes an entire network or subsystem, such as a dam or a levee. It also may not be applied to noninfrastructure capital assets. (As indicated in paragraph 7.01, buildings, except those that are an ancillary part of a network of infrastructure assets, are not considered infrastructure assets.)

7.46 Governments that meet two requirements as discussed in paragraphs 7.47–.48 can elect to use the modified approach for eligible infrastructure assets in lieu of the depreciation method. If a government applies the modified approach to a network of infrastructure assets, the two qualifying requirements have to be met for that network. If a government applies the modified approach to a subsystem of infrastructure assets, the two qualifying requirements have to be met for that subsystem.

7.47 The first requirement for using the modified approach is for the government to have an asset management system with certain features. The system has to have an up-to-date inventory of the infrastructure assets, and it has to estimate the annual costs to maintain and preserve those assets at the condition level the government has established and disclosed through administrative or executive policy or legislative action. The system also has to assess the condition of the assets at least every three years, summarizing the results using a measurement scale (for example, by using a condition index or by stating the percentage of the assets that are in good or poor condition). Condition assessments may be performed based on statistical samples[10] of the assets or on a cyclical basis (for example, a sample drawn from one-third of all the assets in the network or subsystem every year for three years.) The condition assessments also have to be documented in such a manner that they can be replicated. Footnote 18 to GASB Statement No. 34 paragraph 23 defines *replicable condition assessments* as those that are based on sufficiently understandable and complete measurement methods such that different measurers using the same methods would reach substantially similar results.

7.48 The second requirement for using the modified approach is that the government document that the eligible infrastructure assets are being preserved approximately at (or above) the condition level the government has established and disclosed. Adequate documentary evidence is a matter of professional judgment because governments' asset management systems and condition assessment methods vary (both among governments and within governments for different networks or subsystems). However, a government that uses the modified approach has to document that it has performed a complete condition assessment of the assets at least every three years. If the government uses a cyclical basis to perform condition assessments, a complete condition assessment is one that, over no more than three years, evaluates all (or statistical samples of) the assets in the network or subsystem in a consistent manner. The government also has to document that the results of the three most recent complete condition assessments provide reasonable assurance that the assets are being preserved approximately at (or above) the intended condition level. GASB Statement No. 34, as amended, does not establish standards for expressing the condition levels of infrastructure assets accounted for using the modified approach.

7.49 GASB Statement No. 34 paragraph 25 provides that with the modified approach, expenditures for additions and improvements to eligible infrastructure assets (which increase the capacity or efficiency of assets rather than preserve their useful lives) are capitalized. All other expenditures, including preservation costs, are expensed in the period incurred.[11]

7.50 GASB Statement No. 34 paragraph 152 permits a government to begin to use the modified approach as long as at least one complete condition assessment is available and it documents that the assets are being preserved approximately at (or above) the intended condition level. GASB Statement No. 34 paragraph 25, as amended by GASB Statement No. 37, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Omnibus—an amendment of GASB Statements No. 21 and No. 34*, paragraph 8 provides that a change to the modified approach should be accounted for as a change in accounting estimate, meaning that depreciation

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[10] GASB Statement No. 34 does not permit the use of haphazard or judgmental samples.

[11] The GASB IG 2015-1 provides guidance on costs expensed versus costs capitalized. See GASB IG 2015-1 questions 7.17.1–7.17.6.

is no longer recorded on the assets and the assets remain recorded at book value (original cost less accumulated depreciation) at the time of the modified approach is adopted. The original cost, which may include capitalized preservation costs, is not restated.

7.51 If a government no longer meets the requirements for using the modified approach or chooses to change from the modified approach to the depreciation method, the assets should be depreciated beginning with the next reporting period. Footnote 21 to GASB Statement No. 34 paragraph 26 states that the change to depreciate the assets should be reported as a change in accounting estimate, meaning that depreciation is applied only prospectively, not retroactively calculated.

7.52 Governments that use the modified approach for eligible infrastructure assets are required to present the following two schedules as required supplementary information (RSI) to allow users to analyze the extent to which there is ongoing preservation of those assets:[12]

a. For at least the three most recent complete condition assessments, the assessed condition of the assets, showing the dates of the assessments

b. For the past five reporting periods, the annual estimate at the beginning of each fiscal year of the amount to maintain and preserve the assets at (or above) the condition level established and disclosed by the government, compared with the amounts actually expensed[13]

The information in the RSI schedules should be for the networks or subsystems for which the modified approach is used, and should be derived from the entity's asset management system described in paragraph 7.47.

7.53 GASB Statement No. 34 paragraph 133 requires certain disclosures to accompany the two schedules discussed in paragraph 7.52. Those disclosures are

a. the basis for the condition measurement and the measurement scale used to assess and report condition.

b. the intended condition level for preserving the assets.

c. factors that significantly affect trends in the reported information, such as changes in the measurement basis and scale and the intended condition level. If there is a change in intended condition level, the government also should disclose an estimate of the effect of that change on the current-year estimate of maintenance and preservation costs.

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[12] Chapters 4, "General Auditing Considerations," and 15, "Audit Reporting," discuss the auditor's responsibility for and reporting on required supplementary information (RSI). Presenting RSI for discretely presented component units is a matter of professional judgment, as discussed in chapter 3, "The Financial Reporting Entity."

[13] If the three most recent complete condition assessments and the estimated and actual amounts to maintain and preserve the infrastructure assets for the previous five reporting periods are not available initially, GASB Statement No. 34 paragraph 153 allows the information presented in the schedules to be presented for as many complete condition assessments and years of estimated and actual expenses as are available.

Specified Conditions Approach for Internally Generated Intangible Assets—Other Than Computer Software

7.54 Intangible assets are considered internally generated if they are (*a*) created or produced by the government or an entity contracted by the government or (*b*) acquired from a third party but require more than minimal incremental effort on the part of the government to begin to achieve their expected level of service capacity.

7.55 Outlays related to identifiable internally generated intangible assets should be capitalized (only in financial statements prepared using the accrual basis of accounting) if all of the following occur:

- Determination of the specific objective of the project and the nature of the service capacity that is expected to be provided by the intangible asset upon the completion of the project
- Demonstration of the technical or technological feasibility for completing the project so that the intangible asset will provide its expected service capacity
- Demonstration of the current intention, ability, and presence of effort to complete or, in the case of a multiyear project, continue development of the intangible asset

Only outlays incurred subsequent to meeting the criteria in the preceding list should be capitalized. Outlays incurred prior to meeting those criteria should be expensed as incurred.

Specified Conditions Approach for Internally Generated Computer Software

7.56 Computer software that is developed in-house by the government's personnel or by a third-party contractor on behalf of the government should be considered internally generated. Internally generated software also includes purchased or licensed commercially available software that is modified using more than minimal incremental effort before being put into operation.

7.57 The activities involved in developing and installing internally generated computer software can be grouped into the following stages:[14]

- *Preliminary project stage.* This stage includes conceptual formulation and evaluation of alternatives, determination of the existence of needed technology, and final selection of alternatives for the development of the software.
- *Application development stage.* This stage includes design of the chosen path (including software configuration and software interfaces), coding, installation to hardware, and testing (including the parallel processing phase).
- *Post-implementation / operation stage.* This stage includes application training and software maintenance.

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[14] Data conversion should be considered an activity of the application development stage only to the extent that it is determined to be necessary to make the computer software operational (that is, in condition for use). Otherwise, data conversion should be considered an activity of the post-implementation/operation stage.

7.58 The criteria in paragraph 7.57 related to the preliminary project stage should be considered met only when the activities in this stage are completed and management implicitly or explicitly authorizes and commits to funding, at least currently in the case of a multiyear project, the software project.[15] Accordingly, outlays associated with activities in the preliminary project stage should be expensed as incurred, and outlays related to activities in the application development stage should be capitalized, in financial statements prepared using the accrual basis of accounting, once the criteria have been met. Such capitalization should cease no later than the point at which the computer software is substantially complete and operational. Outlays associated with activities in the post-implementation/operation stage should be expensed as incurred.

7.59 Internally generated modifications of computer software that is already in operation should be capitalized as discussed in paragraph 7.58 and if the modification results in any of the following:

- An increase in the functionality of the computer software (the computer software is able to perform tasks that it was previously incapable of performing)
- An increase in the efficiency of the computer software (an increase in the level of service provided by the computer software without the ability to perform additional tasks)
- An extension of the estimated useful life of the software

If the modification does not result in any of the preceding outcomes, the modification should be considered maintenance, and the associated outlays should be expensed as incurred.

Interfund Movements and Intra-Entity Transfers of Capital Assets

7.60 A government may move capital assets from one proprietary or fiduciary fund to another. It also may move general capital assets to a proprietary or fiduciary fund (or vice versa). (There also may be a movement of related debt at the same time.) These capital asset movements are accounted for at the asset's book value (original cost less accumulated depreciation, if any) at the time of the movement. Consequently, no gain or loss is recognized in a proprietary or fiduciary fund from which the asset is moved. Further, because general capital assets are not capitalized in governmental funds, there is no accounting effect in those funds for movements of general capital assets. The government-wide financial statements should report internal activity for such movements between the governmental and business-type activities. The asset's book value should be moved from one column to the other and equal, offsetting internal activity should be reported and then eliminated in the total primary government column. GASB IG 2015-1 question 7.10.4 states that capitalized interest should not be removed from the cost of capital assets that are moved from an enterprise fund to governmental activities.

7.61 If, for example, a government moves a general capital asset to a proprietary fund, only the proprietary fund should report the movement at the fund level. GASB IG 2015-1 question 7.74.4 states that the proprietary fund would classify the movement as a capital contribution (in the last section of the

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[15] For commercially available software that will be modified to the point that it is considered internally generated, the noted criteria generally could be considered to have occurred upon the government's commitment to purchase or license the computer software.

statement of revenues, expenses, and changes in net position). It also states that both sides of the movement should be reported in the government-wide statement of activities as a transfer from governmental activities to business-type activities. The fact that the movement affects government-wide activities but not the governmental funds should be reported as a reconciling item between the governmental fund and governmental-wide financial statements. (See the discussion of financial statement reconciliations in chapter 10, "Net Position and Financial Statement Reconciliations.")

7.62 GASB Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues*, as amended, discusses, in part, intra-entity transfers of assets, including capital assets. It states that when accounting for the transfer of capital assets within the same financial reporting entity, the transferee should recognize the assets received at the carrying value of the transferor (that is, they should not be revalued). In some jurisdictions, different capitalization thresholds may be adopted for governmental and proprietary funds. Therefore, it would be possible for a transferred asset to be transferred with a carrying value of zero because it did not meet the transferring fund's capitalization threshold even though the asset would have originally been capitalized in the receiving fund.[16] See chapter 6 and chapter 9, "Interfund, Internal, and Intra-Entity Activity and Balances," for further discussion of GASB Statement No. 48.

Capital Assets Used in Landfills

7.63 GASB Statement No. 18, *Accounting for Municipal Solid Waste Landfill Closure and Postclosure Care Costs*, as amended, establishes specialized accounting and financial reporting standards for equipment and facilities relating to municipal solid waste landfills. See that statement as well as the discussion of closure and postclosure care liabilities in chapter 8.

Update 7-2 *Asset Retirement Obligations*

GASB Statement No. 83, *Certain Asset Retirement Obligations*, defines an *asset retirement obligation* (ARO) as a legally enforceable liability associated with the retirement of a tangible capital asset. This liability is incurred as a result of external obligating events such as (*a*) approval of federal, state, or local laws or regulations; (*b*) creation of a legally binding contract; or (*c*) issuance of a court judgment, or internal obligating events as outlined in paragraph 10 of the statement. The statement establishes accounting and financial reporting guidelines for AROs, including requirements for initial and subsequent measurement and recognition of the liability and related deferred outflows of resources, as well as required note disclosures as outlined in paragraphs 27–29 of the statement.

The statement was issued in November 2016 and will be effective for reporting periods beginning after June 15, 2018. Earlier application is encouraged.

The full text of the statement is available on GASB's website at www.gasb.org.

[16] GASB IG 2015-1 question Z.48.4, as amended, describes situations in which two parts of the same reporting entity have differing capitalization policies and reiterates that the transfers discussed in this section are to be made at the transferor's net book value, regardless of whether the receiving function would have, or would not have, capitalized the asset under its own capitalization policy at some other value, or no value, had it purchased it or otherwise acquired it, such as through donation, from a party outside the reporting entity.

Capital Assets Used in Pollution Remediation

7.64 GASB Statement No. 49, as amended, establishes specialized accounting and financial reporting standards for equipment and facilities relating to pollution remediation obligations. In most cases, pollution remediation outlays, including outlays for property, plant, and equipment, should be reported as an expense when a liability is recognized. In certain circumstances, pollution remediation outlays should be capitalized in the government-wide and proprietary fund statements. See that statement as well as the discussion of pollution remediation liabilities in chapter 8.

Service Concession Arrangements

7.65 GASB Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements*, as amended, establishes accounting and financial reporting standards for service concession arrangements. A service concession arrangement is an arrangement between a government (the transferor) and an operator in which all of the following criteria are met:

a. The transferor conveys to the operator the right and related obligation to provide public services through the use and operation of a capital asset (a *facility*) in exchange for significant consideration, such as an up-front payment, installment payments, a new facility, or improvements to an existing facility.

b. The operator collects and is compensated by fees from third parties.

c. The transferor determines or has the ability to modify or approve what services the operator is required to provide, to whom the operator is required to provide the services, and the prices or rates that can be charged for the services.

d. The transferor is entitled to significant residual interest in the service utility of the facility at the end of the arrangement.

Service concession arrangements include, but are not limited to, the following:

a. Arrangements in which the operator will design and build a facility and will obtain the right to collect fees from third parties (for example, construction of a municipal complex for the right to lease a portion of the facility to third parties)

b. Arrangements in which the operator will provide significant consideration in exchange for the right to access an existing facility (for example, a parking garage) and collect fees from third parties for its usage

c. Arrangements in which the operator will design and build a facility for the transferor (for example, a new tollway), finance the construction costs, provide the associated services, collect the associated fees, and convey the facility to the government at the end of the arrangement

Accounting and Financial Reporting by the Governmental Transferor

7.66 If the facility associated with a service concession arrangement is an existing facility, the transferor should continue to report the facility as a capital asset. If the facility associated with a service concession arrangement is a new facility purchased or constructed by the operator, or an existing facility that has been improved by the operator, the transferor should report (*a*) the new facility or the improvement as a capital asset at acquisition value when it is placed in operation, (*b*) any contractual obligations as liabilities, and (*c*) a corresponding deferred inflow of resources equal to the difference between *a* and *b*. After initial measurement, the capital asset is subject to existing requirements for depreciation (except as noted in paragraph 7.67), impairment, and disclosures. The capital asset should not be depreciated if the service concession arrangement requires the operator to return the facility to the transferor in its original or an enhanced condition.

7.67 The corresponding deferred inflow of resources should be reduced and revenue should be recognized in a systematic and rational manner over the term of the service concession arrangement, beginning when the facility is placed into operation.

7.68 Improvements made to the facility by the operator during the term of the service concession arrangement should be capitalized by the transferor as they are made and also are subject to existing requirements for depreciation, impairment, and disclosures.

Accounting and Financial Reporting by the Governmental Operator

7.69 A governmental operator should report an intangible asset for the right to access the facility and collect third-party fees from its operation at cost (for example, the amount of upfront payment or the cost of construction of or improvements to the facility). The cost of improvements to the facility made by the governmental operator during the term of the service concession arrangement should increase the governmental operator's intangible asset if the improvements increase the capacity or efficiency of the facility. The intangible asset should be amortized over the term of the arrangement in a systematic and rational manner.

7.70 Accounting and financial reporting for various types of service concession arrangements is also discussed in chapters 8–9.

Disclosures[17]

7.71 GASB Statement No. 34 paragraphs 116–117, as amended, require governments to provide details in the notes to the financial statements about the primary government's capital assets reported in the government-wide statement of net position. The information in the disclosure should be divided into major classes of capital assets as well as between type of activity (governmental versus business-type). Capital assets that are not being depreciated should be disclosed separately from those that are being depreciated. Information by major classes of capital assets should include beginning- and end-of-year balances (with accumulated depreciation presented separately from historical cost), capital acquisitions, sales or other dispositions, and current-period depreciation expense. The amount of depreciation charged to each function in the statement of activities also should be disclosed. These disclosures should include capitalized collections of works of art, historical treasures, and similar assets. For collections that are not capitalized, GASB Statement No. 34 paragraph 118 requires the government to disclose a description of the collection and the reasons those assets are not capitalized.

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[17] Making disclosures for discretely presented component units is a matter of professional judgment, as discussed in chapter 3.

7.72 The following are among the other disclosures required for capital assets:

- The policy for capitalizing assets and for estimating the useful lives of those assets that are used to calculate depreciation expense (GASB Statement No. 34 paragraph 115, as amended)
- A general description of the method or methods used to compute depreciation with respect to major classes of depreciable assets, as required by GASB Statement No. 62 paragraph 95[18]
- If using the modified approach for reporting eligible infrastructure assets, a description of that approach (GASB Statement No. 34 paragraph 115, as amended)
- Pertinent data regarding capital leases (GASB Statement No. 62 paragraphs 211–271, as amended)
- If not otherwise apparent from the face of the financial statements, a general description, the amount, and the financial statement classification of capital asset impairment losses (GASB Statement No. 42 paragraph 17, as amended)
- The carrying amount of impaired capital assets that are idle at year-end, regardless of whether the impairment is considered permanent or temporary (GASB Statement No. 42 paragraph 20)
- Construction commitments (NCGA Statement 1 paragraph 158 and NCGA Interpretation 6, *Notes to the Financial Statements Disclosure*, paragraph 4)
- Information related to service concession arrangements by transferors and governmental operators (GASB Statement No. 60 paragraphs 16–18)

Management's Discussion and Analysis

7.73 GASB Statement No. 34, as amended, requires the presentation of a management's discussion and analysis (MD&A) as discussed in chapter 2. Two of the requirements for presentation in MD&A, which is RSI,[19] involve capital assets. Those items are

- significant capital asset activity during the year, including a discussion of commitments made for capital expenditures. (As an alternative, governments may summarize the information in the disclosures discussed in paragraph 7.71 and refer to it for additional details.)
- for governments that use the modified approach to report eligible infrastructure assets, (*a*) significant changes in the assessed condition of eligible infrastructure assets from previous condition assessments, (*b*) how the current assessed condition compares with the condition level the government has established, and (*c*) significant differences between the actual amounts spent during the current year to maintain and preserve eligible infrastructure assets and the estimated annual amount.

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[18] GASB Statement No. 38, *Certain Financial Statement Note Disclosures*, paragraph 5 states that disclosure in the notes to the financial statements is needed only when the information required to be disclosed is not displayed on the face of the financial statements.

[19] See footnote 11.

7.74 As discussed in chapter 2, MD&A also should include a description of currently known facts, decisions, or conditions that are expected to have a significant effect on financial position or results of operations. Examples of currently known facts, decisions, or conditions related to capital assets that might be expected to have a significant effect on financial position or results of operations could be: the award and acceptance of a major capital grant; a successful bond referendum for capital improvement or construction; the failure of a referendum to renew a property tax millage dedicated for capital improvement; a vote by the governing board to significantly change the condition level the government will use in the future to preserve and maintain infrastructure assets accounted for using the modified approach; and the finalization of contracts to rebuild a school heavily damaged by a fire.

Auditing Considerations[20]

7.75 The audit objectives for the capital assets and related accounts of each opinion unit, categorized by financial statement assertion, are as follows:

- *Assertions about classes of transactions and events for the period under audit*:
  - *Occurrence.* Reported capital expenditures and depreciation and amortization expense represent amounts relating to the period and pertain to the government.
  - *Completeness.* The financial statements report all capital expenditures and depreciation and amortization expense relating to the period.
  - *Accuracy.* Amounts and other data relating to capital expenditures and depreciation and amortization expense have been recorded appropriately.
  - *Cutoff.* Amounts and other data relating to capital expenditures and depreciation and amortization expense have been recorded in the correct accounting period.
  - *Classification.* Amounts and other data relating to capital expenditures and depreciation and amortization expense have been recorded in the proper accounts.
- *Assertions about account balances at the period end*:
  - *Existence.* Reported capital assets represent items owned or otherwise required to be reported (such as capital assets acquired through capital lease or intangible assets required to be capitalized), considering the entity's capitalization policies, as of the end of the period.
  - *Rights and obligations.* The financial statements properly reflect conditions and agreements that affect the entity's rights and obligations concerning capital assets as of the end of the period.

[20] Chapter 8, "Expenses or Expenditures and Liabilities," also discusses internal control features and auditing procedures applicable to capital asset acquisitions.

- *Completeness*. The financial statements report all capital assets and accumulated depreciation and amortization as of the end of the period.
- *Valuation and allocation*. Capital assets and accumulated depreciation and amortization are reported at the proper amounts.

- *Assertions about presentation and disclosure*:
  - *Occurrence and rights and obligations*. Disclosed capital assets, accumulated depreciation, accumulated amortization, capital expenditures, and depreciation and amortization expense have occurred and pertain to the government.
  - *Completeness*. All disclosures relating to capital assets, accumulated depreciation, accumulated amortization, capital expenditures, and depreciation and amortization expense that should have been included in the financial statements have been included.
  - *Classification and understandability*. Capital asset, accumulated depreciation, accumulated amortization, capital expenditure, and depreciation and amortization expense financial information is appropriately presented and described and disclosures are clearly expressed.
  - *Accuracy and valuation*. The financial statements properly classify, describe, and disclose the activity and balances relating to capital assets, including classification in the proper fund and activity. Financial statement presentation and disclosure are made in accordance with generally accepted accounting principles (GAAP), consistently applied.

7.76 The auditor should determine that adequate procedures are performed related to each of those opinion units with material capital asset activity and balances. (See the discussion of opinion units in chapter 4.) According to paragraph .13 of AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), the auditor should obtain an understanding of the government's internal control relevant to the audit, including controls over capital assets and related accounts. In addition to standard internal control features for those assets and accounts, features that are unique or significant in government may include policies and procedures that will

- ensure that capital asset acquisitions and dispositions are initiated and administered in accordance with budgetary and other legal and contractual provisions.
- define and identify the infrastructure assets that are owned or otherwise required to be reported by the government.
- define and identify the intangible assets that are owned and required to be reported as capital assets by the government.
- ensure the proper calculation and recording of depreciation expense, including functional allocations.

- ensure the proper calculation and recording of capital asset impairments.
- properly record any transfers of capital assets and related debt between funds, component units, or other entities.
- ensure that the asset management system and the documentation of the condition of the assets comply with the standards in GASB Statement No. 34, as amended, if eligible infrastructure assets are accounted for using the modified approach.
- ensure that all appropriate GAAP-required disclosures are made in the financial statements.
- ensure that capital assets are maintained and disposed of in accordance with the requirements of the funding source used to acquire the assets (for example, state grants).

7.77 In addition to standard audit procedures for capital assets and related accounts and in addition to the audit considerations and procedures discussed in paragraphs 7.78–.91, procedures relating to those assets and accounts that are unique or significant in government may include the following:

- Reviewing underlying documentation (such as statutes and regulations, governing board minutes, grant contracts and donor letters, acceptance ordinances, and contracts to lease or sell capital assets) and interviewing the entity's management to determine legal and contractual provisions relating to capital assets and related accounts that could have a direct and material effect on the determination of financial statement amounts
- Comparing the entity's budgeted and actual capital outlays for the period and investigating significant variances
- Determining whether the entity has satisfactory title to capital assets or other evidence supporting the reporting of infrastructure assets (see also paragraph 7.81) and certain intangible assets (patents, copyrights, and trademarks), whether any liens exist, or whether any capital assets have been pledged
- Evaluating whether depreciation expense is properly charged to the various functions
- Evaluating whether capital asset impairments have been properly reported
- Evaluating whether transfers of capital assets and related debt between funds, component units, and other entities have been properly reported
- If eligible infrastructure assets are accounted for using the modified approach, determining that the asset management system and the documentation of the condition of the assets comply with the standards in GASB Statement No. 34, as amended, (see the further discussion in paragraphs 7.83–.91.)
- Evaluating whether financial statement disclosures for capital assets and related accounts are in accordance with GAAP

Capital Asset Records

7.78 A government's accounting records may not be adequate to provide audit evidence to support the financial statement assertions for capital asset accounts. Some entities have not maintained or reconstructed detailed records of their capital assets, especially older assets. Without detailed records, it may be particularly difficult for the entity to provide persuasive support for calculating depreciation expense, recording and reporting capital asset dispositions, and allocating depreciation expense among functions. The auditor should use professional judgment in evaluating whether and to what extent the lack of detailed capital assets records affects the auditor's report on the financial statements. Factors that the auditor might consider include the relative significance of those capital assets for which detailed records do not exist compared to those for which they do, the existence of other audit evidence to support the applicable financial statement assertions, and the materiality of the capital assets and related accounts to the opinion unit reporting those accounts. The auditor also should consider whether the lack of records constitutes a significant deficiency in internal control (including whether it constitutes a material weakness) that should be communicated to management and those charged with governance or other related parties in accordance with AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*).

7.79 GASB Statement No. 34, as amended, requires certain disclosures about capital assets to be divided into major classes of capital assets; it also provides that certain assets are inexhaustible or may be accounted for using the modified approach and thus not subject to depreciation. If a government has not separately identified its major classes of capital assets or nondepreciable capital assets in its capital asset records, it either cannot conform with or provide support of its conformity with those GAAP requirements. The auditor's considerations in that situation are the same as for the lack of detailed records for capital asset, as discussed in paragraph 7.78.

7.80 Governments may reconstruct, expand, or refine their capital asset records to provide the information needed to conform with GAAP. Reconstruction of those records may be based on actual historical data or on estimation procedures. In the period that a government reconstructs or expands its capital asset records, the auditor should perform procedures normally applied to capital asset additions to all new information in the records (even though the entries represent previously owned assets). If the government uses a management's specialist to assist in the reconstruction of its capital assets records, AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*), provides requirements and guidance when using the work of a management's specialist. The auditor may recommend that the government retain a permanent record of the matters addressed during the reconstruction or expansion of its capital asset records to provide ongoing support for the amounts in future periods. The auditor also should consider documenting the procedures performed and the result in the audit documentation (perhaps through a summary memo).

Ownership of Infrastructure Assets

7.81 The auditor may consider reviewing title documents, plat maps, capital grant agreements, accounting records for maintenance and repair costs, board minutes, engineering department logs, and maintenance department work orders to evaluate the auditee's ownership of or (if ownership is unclear) responsibility for managing infrastructure assets. The auditor also may consider making inquiries of management and the entity's legal counsel and obtaining written management representations that address the ownership or management of infrastructure assets to provide corroborating evidence for the reporting of infrastructure assets.

Useful Lives of Infrastructure Assets

7.82 To depreciate infrastructure assets, a government needs to, among other things, estimate the assets' useful lives. It may be difficult to establish estimated useful lives for infrastructure assets with reasonable certainty because, by definition, they normally can be preserved for a significantly greater number of years than other capital assets. The auditor should consider determining that the entity has evaluated appropriate factors in establishing those lives. In making such a determination, the auditor may consider whether the entity has appropriately modified its estimate of the remaining useful lives of assets over the years, as evidence becomes available that the likely useful lives are longer or shorter than originally set. Sources of information about estimated useful lives of infrastructure assets include engineering professionals, appropriate federal agencies and industry associations (such as the U.S. Federal Highway Administration and the American Public Works Association), and other governments in close proximity with similar infrastructure assets. Useful lives that are based on arbitrary measures, such as the length of the term of bonds used to finance the assets, may not appropriately represent the assets' estimated useful lives. In evaluating an entity's estimate of useful lives for infrastructure assets, the auditor also could consider whether the entity has evaluated the other factors discussed in paragraph 7.28 and footnote 8.

Modified Approach for Infrastructure Assets

Costs That Extend Initial Estimated Useful Lives

7.83 Usually, after a capital asset is placed into service, expenditures that extend its initial estimated life are capitalized. However, under the modified approach, that is not the case. As discussed in paragraph 7.49, only expenditures that increase the original capacity or efficiency of those assets are capitalized. The auditor should consider this nuance in evaluating the entity's capitalization policy relating to infrastructure assets accounted for using the modified approach.

Condition Assessments

7.84 To use the modified approach, GASB Statement No. 34 paragraph 24 requires the government to document that the three most recent complete condition assessments provide reasonable assurance that the eligible infrastructure assets are being preserved approximately at (or above) the condition level established and disclosed by the government.[21] There are two interrelated matters involved in determining whether a government has met that requirement. One is whether and to what extent the three individual condition assessments could be below the established condition level. (See paragraph 7.85.) The other is whether a single substandard condition assessment constitutes a breach of the requirement. (See paragraph 7.86.)

7.85 The standard's use of the term *approximately* allows flexibility. The actual condition levels do not have to equal or exceed the condition level established by the government; a reasonable variance below the established level is

[21] GASB Statement No. 34 permits governments to begin to use the modified approach with only one complete condition assessment. See paragraph 7.50.

permissible. The auditor could view "reasonableness" in this context in different ways, for example

- the percentage variance between the actual and established condition levels. (For example, an actual level of 72 would vary from an established level of 75 by four percent; that is, 72 is 96 percent of 75.)
- the relative cost, size, or other measure of assets in the network or subsystem that fail to meet the established condition level compared to the total cost, size, or other measure of all of the assets in the network or subsystem.

7.86 GASB Statement No. 34, as amended, does not specify that a single substandard condition assessment constitutes a breach of the requirement. If that had been the intent, the use of the modified approach would have been conditioned on *each* complete condition assessment providing reasonable assurance that the eligible infrastructure assets are being preserved approximately at (or above) the established condition level. The requirement to consider the results of the *three* most recent condition assessments encourages the preparer and auditor to take a broader perspective to the evaluation and consider the three condition assessments together as a whole. One approach would be to consider the trend of the three most recent condition assessments; an upward trend would be more "reasonable" than a downward trend. However, the nature and circumstances surrounding a single substandard condition assessment might lead to a conclusion that the three most recent condition assessments, as a whole, do not provide the stipulated reasonable assurance. The auditor should exercise professional judgment in evaluating whether a single substandard condition assessment taken together with the two other assessments provide reasonable assurance that the eligible infrastructure assets are being preserved approximately at (or above) the established condition level.

7.87 An auditor cannot evaluate the results of a condition assessment until it is complete, which GASB Statement No. 34, as amended, permits to take up to three years. GASB Statement No. 34, as amended, also does not require that condition assessment activities be conducted every year; it only requires that a complete condition assessment be conducted at least every three years. Therefore, an entity may disclose in its summary of significant accounting policies that it uses the modified approach to account for eligible infrastructure assets even though there has been no condition assessment activity during the period. When this occurs, the auditor should follow the guidance in AU-C section 580, *Written Representations* (AICPA, *Professional Standards*), if a specific written representation from management regarding the entity's intent to use the modified approach is requested. To substantiate that intent, the auditor could, for example, review minutes of governing board meetings, compare the year's actual maintenance/preservation costs to the estimated amount, and discuss the plans for future condition assessment activity with the staff that perform the assessments. If the entity does not represent that it intends to continue to use the modified approach (for example, if it represents that it intends to change to the depreciation method before the next complete condition assessment is required), the auditor should consider whether that intention affects the carrying value of the assets, is adequately disclosed in the financial statements, and affects the auditor's report on the financial statements.

7.88 GASB Statement No. 34, as amended, requires condition assessments to be documented in such a manner that they can be replicated. (See paragraph

7.47.) Determining whether a condition assessment is replicable does not require the auditor to reperform all or part of the condition assessment, although such a procedure could be used. Instead, in evaluating whether condition assessments are replicable, the auditor could consider, for example, internal control over the input and output of information and the extent to which the procedures needed to use the method are documented. If a condition assessment is found not to be replicable and the entity continues to apply the modified approach in the subsequent reporting period, which constitutes a departure from GAAP, not a scope limitation.

7.89 Management may engage a management's specialist to develop the condition assessment method or to perform the condition assessments.[22] Further, the auditor may engage an auditor's specialist to evaluate whether a condition assessment is replicable. In those situations, AU-C section 620, *Using the Work of an Auditor's Specialist* (AICPA, *Professional Standards*), provides requirements and guidance when using the work of an auditor's specialist. If a government uses another organization to perform its condition assessments and those services are part of the government's information system, that other organization meets the definition of a service organization. AU-C section 402, *Audit Considerations Relating to an Entity Using a Service Organization* (AICPA, *Professional Standards*), provides requirements and guidance on the factors auditors (referred to as user auditors) should consider when auditing financial statements of an entity that uses a service organization to process certain transactions. As an aside, AT-C section 320, *Reporting on an Examination of Controls at a Service Organization Relevant to User Entities' Internal Control Over Financial Reporting* (AICPA, *Professional Standards*), and the AICPA Guide *Service Organizations—Reporting on Controls at a Service Organization Relevant to User Entities' Internal Control Over Financial Reporting*, provide guidance for independent auditors (service auditors) who issue reports on processing of transactions by service organizations for use by other auditors.

7.90 Footnote 18 to GASB Statement No. 34 paragraph 23 permits condition assessments to be performed by the government itself or by contract. GASB IG 2015-1 question 7.19.3 states that there are no minimum training requirements for staff that manage an asset management system. However, the level of expertise and experience of the persons conducting the assessments is an element of internal control over the inputs and outputs of the information. Therefore, in evaluating that internal control, the auditor should evaluate the qualifications of the individuals who perform the condition assessments, including their educational background, experience in performing condition assessments (especially with the types of infrastructure assets for which they are currently performing condition assessments), objectivity, and the nature and level of training on consistently applying the measurement method.

7.91 The auditor also should consider evaluating whether complete condition assessments have been performed in a consistent manner, as required by GASB Statement No. 34 paragraph 24. GASB IG 2015-1 question 7.20.11 states that consistency is achieved if the entire condition assessment is performed using the same condition assessment method, basis for the condition

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[22] A government's use of a management's specialist does not eliminate or minimize the asset management system or documentation requirements for using the modified approach discussed in paragraphs 7.46–.48. If a management's specialist is used, the government will need to either maintain the documentation or be able to access or obtain it from the management's specialist, even if the management's specialist uses a proprietary product.

measurement, and measurement scale. A government may change the method, basis, or scale before beginning the subsequent complete assessment. For example, if a government performs its condition assessment over a three-year cycle, and changes the method, basis, or scale during the third year of the cycle, it would have to perform a condition assessment on all (or a statistical sample) of the subject assets during that third year using the new method, basis, or scale. Alternatively, the government could complete the cyclical condition assessment using the old method, basis, or scale, and make the change at the beginning of the next assessment cycle. If changes are made in the method, basis, or scale used during the periods covered by the RSI schedules, the auditor's procedures required for RSI (as discussed in chapter 4) should alert the auditor to whether those changes are appropriately disclosed as described in paragraph 7.53.

Chapter 8

Expenses or Expenditures and Liabilities

Introduction

8.01 Expenses or expenditures[1] and liabilities represent outflows of resources[2] from the government that are applicable to the reporting period. Because expense/expenditure and liability transactions are closely related, many audit procedures satisfy the audit objectives of both types of accounts at the same time. That is, evidence that supports assertions about expenses or expenditures also generally supports assertions about liabilities. This chapter discusses accounting, financial reporting, and auditing considerations relating to various transactions and events that result in expenses or expenditures, liabilities, and deferred outflows of resources. Chapter 7, "Capital Assets," discusses accounting, financial reporting, and certain auditing considerations for expenses or expenditures for capital assets.[3]

Update 8-1 ***Asset Retirement Obligations***

GASB Statement No. 83, *Certain Asset Retirement Obligations*, defines an asset retirement obligation (ARO) as a legally enforceable liability associated with the retirement of a tangible capital asset. This liability is incurred as a result of external obligating events such as: (*a*) approval of federal, state, or local laws or regulations; (*b*) creation of a legally binding contract; or (*c*) issuance of a court judgment, or internal obligating events as outlined in paragraph 10 of the statement. The statement establishes accounting and financial reporting guidelines for AROs, including requirements for initial and subsequent measurement and recognition of the liability and related deferred outflows of resources, as well as required note disclosures as outlined in paragraphs 27–29 of the statement.

The statement was issued in November 2016 and will be effective for reporting periods beginning after June 15, 2018. Earlier application is encouraged.

The full text of the statement is available on GASB's website at www.gasb.org.

GASB Statement No. 83 will affect the guidance in this chapter upon its effective date.

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[1] In general, this chapter does not discuss interfund transfers, loans, or reimbursements; see chapter 9, "Interfund, Internal, and Intra-Entity Activity and Balances," for those items. The terms *expenses* and *expenditures* are used in a generic manner throughout much of this chapter to refer to the resource outflows from other than interfund transfers that are reported in a government's activity statements. GASB standards require different classifications of those reported resource outflows in the various activity statements, as discussed later in this chapter.

[2] GASB Concepts Statement No. 4, *Elements of Financial Statements*, defines an *outflow of resources* as the consumption of net assets by the government that is applicable to the reporting period. Net assets may be consumed directly when acquired from an external party or may be consumed after being under control of the government for a period of time. Consumptions of net assets result in either (*a*) a decrease in assets in excess of any related decrease in liabilities or (*b*) an increase in liabilities in excess of any related increase in assets. Employees providing government services for which they will be paid in the next reporting period and loss of a government building due to fire are examples of the consumption of net assets by a government.

[3] Although chapter 7, "Capital Assets," discusses accounting, financial reporting, and auditing considerations for the acquisition and use of capital assets, this chapter's discussions of internal control features and auditing procedures also apply to capital asset acquisitions.

Nature of Transactions

Update 8-2 *Fiduciary Activities*

GASB Statement No. 84, *Fiduciary Activities*, establishes criteria for identifying and reporting fiduciary activities. The criteria for identification of fiduciary activities primarily focuses on (*a*) whether a government controls the assets of the fiduciary activity and (*b*) the beneficiaries with whom a fiduciary relationship exists.

Governments with activities meeting the criteria will present a statement of fiduciary net position and a statement of changes in fiduciary net position, with certain exceptions.

There are four classifications of fiduciary funds described in GASB Statement No. 84: (1) pension (and other employee benefit) trust funds, (2) investment trust funds, (3) private-purpose trust funds, and (4) custodial funds. Custodial funds should report fiduciary activities that are not held in a trust or equivalent arrangement that meets specific criteria. Note that agency funds will no longer be reported upon application of this statement.

The statement was issued in January 2017 and is effective for fiscal years beginning after December 15, 2018. Earlier application is encouraged.

Upon its effective date, GASB Statement No. 84 will affect the guidance in this chapter.

The full text of the statement is available on GASB's website at www.gasb.org.

8.02 The resource outflows that a particular governmental activity statement reports results from its measurement focus and basis of accounting (MFBA). The government-wide, proprietary fund, and trust fund[4] financial statements, which use the economic resources/accrual MFBA, report expenses. The governmental fund financial statements, which use the current financial resources/modified accrual MFBA, report expenditures. The primary differences between expenses and expenditures relate to (*a*) the acquisition of capital assets versus their use, (*b*) the issuance and payment of long-term debt, and (*c*) certain current-period costs for which payment normally is not due until future periods.

8.03 Many resource outflows are reported based primarily on events or transactions that require cash disbursements during the current period or shortly thereafter; examples are payroll, rent, utilities, and capital asset acquisitions. Other resource outflows are reported based primarily on known or estimated future-period cash disbursements; examples are compensated absences, and claims and judgments. Still other resource outflows are reported based on the known or estimated use of items acquired through prior-period cash disbursements and reported as assets; examples are depreciation of capital assets, allocations of prepaid items, and the use of inventory items.

[4] This chapter refers to *trust funds* rather than to *fiduciary funds* because a government's basic financial statements do not include activity statements for agency funds.

8.04 Deferred outflows of resources and deferred inflows of resources arise when governments enter into transactions that result in the consumption or acquisition of net assets in one period that are applicable to future periods. According to GASB Concepts Statement No. 4, *Elements of Financial Statements*, recognition of deferred outflows of resources and deferred inflows of resources should be limited to those instances identified by GASB in authoritative pronouncements. GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*; GASB Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements*; GASB Statement No. 65, *Items Previously Reported as Assets and Liabilities*; GASB Statement No. 68, *Accounting and Financial Reporting for Pensions—an amendment of GASB Statement No. 27*, as amended; GASB Statement No. 69, *Government Combinations and Disposals of Government Operations*; GASB Statement No. 73, *Accounting and Financial Reporting for Pensions and Related Assets That Are Not within the Scope of GASB Statement 68, and Amendments to Certain Provisions of GASB Statements 67 and 68*; and GASB Statement No. 81, *Irrevocable Split-Interest Agreements*, contain those requirements and are discussed in chapter 2 "Financial Reporting."

Update 8-3 *Accounting and Reporting*: Deferred Outflows of Resources and Deferred Inflows of Resources

GASB Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*, requires that changes in the net or total postemployment benefits other than pensions (OPEB) liability, as applicable, that have not been included in OPEB expense are required to be reported as deferred outflows of resources or deferred inflows of resources related to OPEB. Additionally, for circumstances in which OPEB is provided through an OPEB plan that is administered through a trust that meets the specified criteria, employer OPEB contributions made subsequent to the measurement date of the net OPEB liability and before the end of the reporting period are required to be reported as deferred outflows of resources. For circumstances in which OPEB is provided through an OPEB plan that is not administered through a trust that meets the specified criteria, amounts paid by the employer for OPEB as the benefits come due subsequent to the measurement date of the total OPEB liability and before the end of the reporting period, and amounts for OPEB administrative expenses incurred subsequent to the measurement date of the total OPEB liability and before the end of the reporting period are required to be reported as deferred outflows of resources.

The statement was issued in June 2015 and is effective for fiscal years beginning after June 15, 2017. Earlier application is encouraged.

Those implementing GASB Statement No. 75 may refer to chapter 14, "Defined Benefit Postemployment Benefits Other Than Pensions (Plan & Employer Considerations)," for guidance related to accounting and reporting for OPEB under the new statement.

GASB Statement No. 83, *Certain Asset Retirement Obligations*, requires a government that has legal obligations to perform future asset retirement activities related to its tangible capital assets to recognize a liability and a corresponding deferred outflow of resources.

GASB Statement No. 83 was issued in November 2016 and is effective for reporting periods beginning after June 15, 2018.

The full text of both statements are available on GASB's website at www.gasb.org.

8.05 Many governments centralize their purchasing, accounts payable, and cash disbursement activities. Small governments usually have a single system to control the ordering and receipt of goods and services, the accounting for expenses or expenditures and liabilities, and cash payments. Larger governments often have multiple systems to control the ordering and receipt of goods and services (for example, purchasing offices for individual departments), but still may account for expenses or expenditures and liabilities and make cash payments through a single system. Some governments may have separate control systems for grant programs or for autonomous departments or agencies. Some governments also have specialized processes to handle small-dollar purchases, such as the use of petty cash funds, debit cards, or procurement cards. Many governments centralize their payroll activities, but multiple systems may exist in certain circumstances. Sometimes, certain of a government's cash payments are made by another entity, such as a financial institution that makes principal and interest payments to individual bondholders.

8.06 Many of a government's expenses or expenditures arise from exchange and exchange-like transactions. However, a government also may have significant amounts of resource outflows arising from nonexchange transactions, such as grants and contributions to other entities and individuals, including pass-through grants that are received from other entities to transfer to or spend on behalf of secondary recipients.

8.07 Activities between the funds of a primary government and between the primary government and its component units also may generate expenses or expenditures and liabilities. Accounting, financial reporting, and auditing considerations for reporting those activities in the financial reporting entity's financial statements are discussed in chapter 9, "Interfund, Internal, and Intra-Entity Activity and Balances." However, the measurement and recognition standards for some of the transactions and other events discussed in this chapter apply to those activities, subject to the provisions concerning interfund, internal, and intra-entity activity and balances of GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, as amended. For example, paragraph 8.60 discusses the treatment of interfund charges for risk financing activities. Although the provisions of GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, as amended, do not apply to activities between the funds of a primary government, they do apply to the recognition and measurement of transactions between a primary government and its component units. However, the provisions of GASB Statement No. 34, as amended, for interfund, internal, and intra-entity activity and balances affect how nonexchange transactions between the primary government and its component units are reported when component units are included with the primary government in the reporting entity's financial statements.

8.08 Liabilities also arise from issuing debt. Governments borrow money on a short-term basis either to meet seasonal cash needs or in advance of future long-term borrowing. Governments usually borrow on a long-term basis to finance capital asset acquisitions, but they also borrow for noncapital purposes, such as to provide the initial funding for a risk-retention program, to pay claims and judgments, to finance an accumulated operating deficit, or to advance the cash flows relating to long-term or delinquent receivables.

8.09 The expense or expenditure and liability activities of governments often are subject to various compliance requirements, such as the following:

- The amount of a government's spending for particular funds, functions, departments, or object classes usually is subject to budgetary constraints. (See chapter 11, "The Budget.") Governments generally control compliance with budgetary spending requirements through the use of an encumbrance system. Encumbrances record formal commitments (usually contracts or purchase orders) to acquire goods or services so that budgetary expenditures do not exceed appropriations.

- State and local laws and regulations, debt agreements (covenants or indentures), and grant agreements often impose requirements for competitive bidding for large-dollar purchases. Those requirements usually are designed to ensure that the government gets the best price for the best goods and services and that all qualified vendors, including small and minority vendors, have an equal opportunity to provide the goods and services. Those requirements also may bar certain vendors from providing goods or services to a government, for example, because of previous problems with procurement contracts.

- Employee arrangements may be affected by state and local laws mandating certain fringe benefits; federal and state laws and regulations mandating the payment of prevailing wage rates on construction projects; civil service requirements for hiring, promoting, and terminating employees; union contracts establishing wage rates and benefits; budgetary authorizations limiting the number of employees authorized by department or function; federal and state laws and regulations relating to overtime, compensatory time, and employment taxes; and intergovernmental grants or private contributions that restrict the maximum personal service costs that can be charged to the program.

- Many intergovernmental grants, entitlements, private contributions, and trust agreements require that amounts provided be spent for particular purposes or during a particular period or that the recipient government provide matching funds or raise matching contributions. They also may require that cash be disbursed within a short time after its receipt from the grantor or contributor. Certain awards may permit a government to charge indirect costs to a grant, sometimes based on an approved indirect cost allocation plan or rate. Those requirements may be listed in the award document, the recipient government's application for assistance (for example, as part of the program budget), or in cost circulars or program regulations.

- State and local laws may impose limits on the amount of debt that a government can issue, and often require approval by senior levels of government or voters to issue debt. Those limitations can apply to all forms of debt, or they may be structured so there are separate limits and voter requirements for different debt forms (for example, general obligation, revenue, installment, and lease purchase debt) or purposes (for example, debt issued for equipment, water and sewer, or transportation purposes). Local governments may not be able to issue debt without explicit authority in state law, and those laws may limit the form of debt that a local government can issue. Other limitations on the form, type, or amount of debt are imposed by federal tax laws and related IRS regulations relating to tax-exempt debt. (See also the discussion in chapter 5, "Investments, Certain Equity Interests, and Derivatives," concerning federal arbitrage requirements.)
- Debt agreements require the payment of principal and interest in established amounts and on established dates and may limit the use of debt proceeds to specific purposes. Some debt agreements restrict other activities of the issuer. For example, they may require (*a*) that the fund that will repay the debt maintain certain levels of equity or changes in equity, (*b*) that particular revenues be used to pay debt service, and (*c*) certain reserve funds, such as a repair and replacement, rate stabilization, or sinking fund to set aside resources for the future payment of debt service obligations. Debt agreements often require the government to file continuing disclosure documents with certain distributing organizations as discussed in chapter 18, "Auditor Involvement With Municipal Securities Filings." Note also that debt agreements (covenants) may also provide trustees with the ability to call outstanding bonds should some or all covenants not be met during the period or as of a specified date.

Although a government should be concerned with all compliance requirements, generally accepted auditing standards focus the auditor's concern on those compliance requirements that could have a direct and material effect on the determination of financial statement amounts. (See the further discussion of the auditor's responsibility in this regard in chapter 4, "General Auditing Considerations.")

8.10 Resource outflows are classified in governmental financial statements in various ways. In the government-wide statement of activities, they are reported as expenses (generally classified by function or different identifiable activity) or special or extraordinary items. In the governmental funds, they are reported as expenditures (generally classified by character and function), other financing uses, special items, or extraordinary items. In the proprietary funds, resource outflows are usually classified as operating expenses, nonoperating expenses, special items, or extraordinary items. The trust funds activity statement classifies resource outflows as *deductions*. See the detailed discussions of the classification of resource outflows in paragraphs 8.106–.113.

Accounting and Financial Reporting Considerations[5]

General Recognition Standards

8.11 The government-wide, proprietary fund, and trust fund financial statements use the economic resources/accrual MFBA. Because of the economic resources measurement focus, those activity statements report expenses, which include the allocation or amortization of costs incurred that are attributed to one or more future periods. Because of the accrual basis of accounting, expenses resulting from exchange and exchange-like transactions are recognized when the exchange takes place; expenses from nonexchange transactions are recognized in accordance with GASB Statement No. 33, as amended, and as explained later in this chapter.

8.12 The governmental funds financial statements use the current financial resources/modified accrual MFBA. Because of the current financial resources measurement focus, governmental funds report expenditures, which generally do not include the allocation or amortization of costs incurred that are attributed to one or more future periods.[6] National Council on Governmental Accounting (NCGA) Statement 1, *Governmental Accounting and Financial Reporting Principles*, paragraph 57, as amended, establishes the standards for the modified accrual recognition of governmental fund expenditures, stating that expenditures should be recognized in the accounting period in which the fund liability is incurred, if measurable, except for unmatured interest on general long-term debt, which should be recognized when due. *Measurable* refers to the ability to reasonably estimate the amount of the expenditure. Other NCGA and GASB pronouncements refine the definition of modified accrual expenditure recognition.[7]

8.13 NCGA Statement 1 paragraph 70, as interpreted, requires that governmental funds accrue liabilities and expenditures in the period in which the government incurs the liability. However, NCGA Statement 1 paragraphs 43–44, as amended, and interpreted, require that the portion of general long-term indebtedness that is not matured (due for payment) be reported as general long-term liabilities of the government, rather than as governmental fund liabilities. That requirement applies not only to formal debt issues but also to other forms of general long-term indebtedness. GASB Interpretation No. 6, *Recognition and Measurement of Certain Liabilities and Expenditures in Governmental Fund Financial Statements—an interpretation of NCGA Statements 1, 4, and 5; NCGA Interpretation 8; and GASB Statements No. 10, 16, and 18*, as amended,

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[5] Presenting note disclosures and required supplementary information (RSI) for discretely presented component units is a matter of professional judgment, as discussed in chapter 3, "The Financial Reporting Entity."

[6] See the alternative to use the consumption method for prepaid items and inventory in governmental funds in paragraphs 8.76–.79.

[7] Although transactions and other events associated with the governmental funds are reported in the fund financial statements using the current financial resources/modified accrual measurement focus and basis of accounting (MFBA), they are reported in the government-wide financial statements using the economic resources/accrual MFBA, typically as governmental activities. That "conversion" from one MFBA to another is explained in the governmental fund financial statements through the presentation of a summary reconciliation to governmental activities in the government-wide financial statements. See the further discussion of those reconciliations in chapter 10, "Net Position and Financial Statement Reconciliations."

clarifies the modified accrual recognition of expenditures and liabilities.[8] It states that governmental funds should report matured liabilities and the related expenditures. Matured liabilities include the following:

- *Liabilities that normally are due and payable in full when incurred.* This includes, for example, liabilities for salaries, professional services, supplies, utilities, and travel. In the absence of an explicit requirement to do otherwise, governmental funds should accrue such liabilities (and expenditures) in the period in which the government incurs the liability.[9]
- *The matured portion of general long-term indebtedness.* Debt service on formal debt issues (such as bonds and capital leases) generally should be recognized as a governmental fund liability and expenditure when due (matured)—with optional additional accrual under certain conditions, as discussed in paragraph 8.89. Compensated absences, claims and judgments, termination benefits, landfill closure, postclosure care costs, and pollution remediation obligations should be recognized as governmental fund liabilities and expenditures to the extent the liabilities are "normally expected to be liquidated with expendable available financial resources." In general, governments are normally expected to liquidate those liabilities with expendable available financial resources to the extent that the liabilities mature (come due for payment) each period. Further, a government may have "other commitments that are not current liabilities properly recorded in governmental funds," which are forms of general long-term indebtedness for which explicit recognition criteria have not been established. For such items, a fund liability and expenditure should be recognized when the payments are due.

8.14 The recognition of expenditures and governmental fund liabilities for compensated absences, claims and judgments, termination benefits, landfill

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[8] The scope of GASB Interpretation No. 6, *Recognition and Measurement of Certain Liabilities and Expenditures in Governmental Fund Financial Statements—an interpretation of NCGA Statements 1, 4, and 5; NCGA Interpretation 8; and GASB Statements No. 10, 16, and 18*, as amended, does not include operating leases with scheduled rent increases (see paragraph 8.72) or employer contributions or benefit payments to (*a*) pension plans (see chapter 13), which should be recognized in accordance with either GASB Statement No. 68, *Accounting and Financial Reporting for Pensions—an amendment of GASB Statement No. 27*, or GASB Statement No. 73, *Accounting and Financial Reporting for Pensions and Related Assets That Are Not within the Scope of GASB Statement 68, and Amendments to Certain Provisions of GASB Statements 67 and 68*, or (*b*) postemployment benefit plans other than pensions (OPEB) (see paragraphs 8.26 and 8.30–.32), which should be recognized in accordance with GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, as amended (see update 8-4).

[9] GASB Technical Bulletin No. 2004-2, *Recognition of Pension and Other Postemployment Benefit Expenditures/Expense and Liabilities by Cost-Sharing Employers*, as amended, provides, in part, that for governmental fund financial statements, which are prepared on the modified accrual basis of accounting, a cost-sharing employer that provides pensions administered through a trust that meets specified criteria should recognize

- a pension or OPEB expenditure equal to the sum of (1) amounts contributed (paid) during the financial reporting period as contractually required contributions for pay periods within that period and (2) any additional unpaid contractually required contributions for one or more pay periods within that period and
- a fund liability for the unpaid contractually required contributions (that is, the unpaid contributions assessed for one or more pay periods within the financial reporting period).

closure and postclosure care costs, and pollution remediation obligation liabilities is based on the maturity of the liabilities and does not depend on how the government accumulates resources to pay those liabilities. Even though some governments advance-fund part or all of the liabilities covered by the "normally expected" criterion, that advance funding should not result in recognizing additional governmental fund expenditures or liabilities.[10] Those accumulated resources should be reported as a part of governmental fund balance as nonspendable, restricted, committed, assigned, or unassigned, if appropriate.

8.15 GASB Statement No. 33 paragraph 14, as amended, requires that governments report net position or fund balance with purpose restrictions as restricted until they use the resources for the specified purpose. The decision whether to first apply unrestricted or restricted resources to specific expenses is a management decision.

8.16 When governments issue long-term debt, the accounting treatment differs depending on the measurement focus used in the financial statements. In the financial statements that use the economic resources measurement focus (government-wide, proprietary fund, and trust fund financial statements), issuing long-term debt results in reporting a liability in the financial position statements, with no effect on the activity statements, except for the expensing of related issuance costs. In the governmental fund financial statements, however, issuing long-term debt generally results in reporting an other financing source in the activity statement. Issuing short-term debt generally results in reporting a liability in all financial position statements, including the governmental funds balance sheet. See the detailed discussion of debt in paragraphs 8.80–.104.

8.17 Governments should record the issuance of debt in the period debt instruments are issued, that is, on the closing date. No amounts are recorded until the debt instruments are issued. If a closing takes place before year-end but proceeds are not received until early in the following year, receivables and liabilities should be reported on the closing date.

Specific Recognition and Financial Reporting Standards

Employment-Related Transactions and Other Events

Compensated Absences

8.18 GASB Statement No. 16, *Accounting for Compensated Absences,* as interpreted by GASB Interpretation No. 6, provides guidance for measuring liabilities for compensated absences, which are absences for which employees will be paid, such as vacation, sick leave, compensatory time, and sabbatical leave. GASB Statement No. 16 provides different liability measures depending on the characteristics of particular benefits. It also provides alternatives—the termination payment method and the vesting method—for recognizing liabilities for sick leave and other compensated absences with similar characteristics. GASB Statement No. 16, as amended, requires (*a*) the compensated absences liability generally to be measured using the pay or salary rates in effect at

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[10] GASB Interpretation No. 6 observes that governments that would prefer accrual-basis recognition of the liabilities covered by the "normally expected" criterion in fund financial statements might consider reporting the activity through a trust or internal service fund.

the reporting date and (*b*) additional amounts to be accrued for certain salary-related payments associated with the payment of compensated absences, for example, the employer's share of social security and Medicare taxes and in some cases the employer's contributions to pension plans. The government-wide and proprietary and trust fund financial statements should recognize compensated absences expenses when the liability is incurred. Using the measurement criteria discussed previously, governmental funds should recognize compensated absences expenditures and report the related fund liabilities as discussed in paragraphs 8.13–.14.

IRC Section 457 Deferred Compensation Plans

8.19 Governments establish IRC Section 457 deferred compensation plans to allow employees to defer part of their pay in a tax-sheltered program. GASB Statement No. 32, *Accounting and Financial Reporting for Internal Revenue Code Section 457 Deferred Compensation Plans—a rescission of GASB Statement No. 2 and an amendment of GASB Statement No. 31*, as amended, requires that such a plan that meets the definition of a pension (and other employee benefit) trust fund be reported in that manner. In evaluating whether to report an IRC Section 457 plan as a trust fund, a government should exercise judgment in determining whether it has fiduciary accountability for the plan and whether it holds the assets in a trustee capacity. If the plan is reported, GASB standards provide guidance on the valuation of plan investments. (See chapter 5.)

Termination Benefits

8.20 GASB Statement No. 47, *Accounting for Termination Benefits*, as amended, requires employers to recognize a liability and expense for voluntary termination benefits (such as early retirement incentives) when the offer is accepted and the amount can be estimated. Employers should recognize a liability and expense for involuntary termination benefits (such as severance benefits) when a plan of termination (as defined in the statement) has been approved by those with the authority to commit the government to the plan, the plan has been communicated to the employees, and the amount can be estimated. Governmental fund financial statements should recognize those liabilities and expenditures to the extent the liabilities are normally expected to be liquidated with expendable available financial resources. When termination benefits include enhancement of pensions or OPEB provided under an existing defined benefit pension plan or OPEB plan, the provisions of GASB Statement Nos. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, as amended, 68, or 73, as appropriate, should be applied.[11]

Pensions

8.21 GASB Statement No. 68 establishes accounting and financial reporting standards for pension expenses or expenditures, and related assets and liabilities by governmental employers whose employees are provided with pensions through pensions plans that are administered through trusts or equivalent arrangements that meet specified criteria, and that are not within the scope of GASB Statement No. 78, *Pensions Provided through Certain Multiple-Employer Defined Benefit Pension Plans*. GASB Statement No. 73 establishes

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[11] GASB IG 2015-1 questions Z.47.1–Z.47.2, as amended, and appendix BZ–1 provide examples of how to compute the liability and expense for termination benefits using various assumptions.

accounting and financial reporting standards for pension expenses or expenditures, and related assets and liabilities by governmental employers whose employees are provided with pensions through pension plans that are not administered through trusts or equivalent arrangements that meet specified criteria as defined in GASB Statement No. 68. Accounting and financial reporting for employers whose employees are provided pensions through pension plans administered through trusts or equivalent arrangements that meet certain criteria defined in GASB Statement No. 68, as amended, and those whose employees are provided with pensions that are not within the scope of GASB Statement No. 68 are described in chapter 13.

OPEB and Termination Benefits—Employer Accounting

Update 8-4 *Accounting and Reporting*: OPEB

GASB Statement No. 75, issued in June 2015, is effective for fiscal years beginning after June 15, 2017. Earlier application is encouraged.

GASB Statement No. 75 establishes measurement criteria for the OPEB liability of state and local governments. The statement requires recognition of the net or total OPEB liability, as applicable , and certain changes in the liability as OPEB expense. This statement is closely related in certain areas and provisions with GASB Statement No. 74, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*.

For OPEB provided through OPEB plans that are administered through trusts that meet the specified criteria, the statement requires recognition of the net OPEB liability, measured as the total OPEB liability (the portion of the actuarial present value of projected benefits that is attributed to past periods of employee service), net of the OPEB plan's fiduciary net position. For OPEB provided through OPEB plans that are not administered through trusts that meet specified criteria, the statement requires recognition of the total OPEB liability.

The OPEB liability should be measured as of a date (measurement date) no earlier than the end of the employer's prior fiscal year. The total OPEB liability is required to be determined by an actuarial valuation as of a date no more than 30 months and one day earlier than the employer's most recent fiscal year end. Additionally, the statement requires the use of the Entry Age Normal actuarial method. The statement also requires a schedule of changes in the net OPEB liability for single and agent multiple employers. The statement also details the note disclosure requirements for OPEB.

The provisions of this statement will affect the guidance in this chapter upon its effective date.

Those implementing GASB Statement No. 75 may refer to chapter 14 for guidance related to employer accounting for OPEB and termination benefits.

The full text of GASB Statement No. 75 is available on GASB's website at www.gasb.org.

8.22 GASB Statement No. 45, as amended, provides guidance on employer accounting and financial reporting for OPEB. OPEB include postemployment health care benefits (such as illness, dental, vision, and hearing), even if those benefits are provided through a pension plan. OPEB also includes, for example, life insurance, disability income, tuition assistance, legal services, and other assistance programs unless the benefits are provided through a defined benefit pension plan. (See chapter 13.) Employers may or may not advance-fund OPEB by setting aside assets on an actuarially determined or other basis to pay future benefits as they become due.

8.23 Accounting and financial reporting requirements for OPEB plans administered through a trust or equivalent arrangement that meets the specified criteria—whether presented in the financial report of a PERS or in the financial report of a plan sponsor or employer—are discussed in chapter 14. See also paragraphs 24–27 and paragraph 34 of GASB Statement No. 45, as amended, for details related to required note disclosures and RSI.

8.24 Paragraph 14 of the GASB IG 2015-1 includes answers to various questions about GASB Statement No. 45.

8.25 In general, governments should account for and report the annual cost of OPEB and the outstanding obligations and commitments related to OPEB on a funding basis as established by GASB Statement No. 45. These amounts should be produced by actuarial valuations performed in accordance with parameters established by GASB in Statement No. 45, as amended (see paragraphs 11–16 of GASB Statement No. 45, as amended, for detailed information related to the parameters).

8.26 GASB Statement No. 45, as amended, provides that the annual required contribution (ARC) and, by extension, the annual OPEB cost, should be determined actuarially using one of six actuarial cost methods described in the statement, as well as other actuarial methods and assumptions consistent with parameters set forth in the statement. If the government's funding methodology is not consistent with the parameters, then the government should select from methods that are consistent for the purposes of financial reporting. The actuarial calculations are required to take into account not only benefits expected to be earned by employees in the future (future normal costs which are not reported currently as they have not yet been earned), but also the actuarial accrued liability (AAL) benefits the employees have already earned (either in past periods or in the current period).

8.27 If an OPEB plan has cash, investments, and other resources, these may be applied to fund the AAL. The value of these resources, for purposes of determining the funded status of the plan and the ARC, is the actuarial value of assets. The actuarial value of assets is not necessarily the same as fair value, which is used to report a plan's investments in the statement of plan net position. For purposes for which the actuarial value of plan assets is used, gains or losses in the fair value of plan assets can be averaged over several years (usually three to five), producing an actuarial value of assets that is more stable over time than fair value.

8.28 The excess of the AAL over the actuarial value of assets is the unfunded AAL (UAAL or unfunded liability). The unfunded liability may be amortized over a period of up to 30 years, either in level dollar amounts or as a level percentage of projected payroll.

8.29 The normal cost and the portion of the UAAL to be amortized in the current period together make up the ARC of the employer for the period. The ARC is an amount that is actuarially determined in accordance with the requirements of GASB Statement No. 45 so that, if paid on an ongoing basis, it would be expected to provide sufficient resources to fund both the normal cost for each year and the amortized unfunded liability. Employer contributions in relation to the ARC (that is, an employer's actual contributions to a pension plan for the period) consist of payments made directly to or on behalf of a retiree or beneficiary, premium payments made to insurers, or assets irrevocably transferred to a trust (or equivalent arrangement) in which plan assets are dedicated to providing benefits to retirees and beneficiaries in accordance with the terms of the plan and are legally protected from creditors of the employer and plan administrator. Employer contributions in relation to the ARC include only the net amounts of employer resource outflows. Therefore they do not include benefit payments or premium payments that have been subsequently reimbursed to the employer from the trust; nor do they include employee premium payments, deductibles, or contributions.

8.30 For a government in a single-employer or agent multiple-employer plan, the annual OPEB cost equals the ARC plus or minus certain adjustments if the employer's actual contributions in prior years differed from the ARC. The annual OPEB cost is the OPEB expense that a government reports in its accrual-based financial statements—the government-wide statements, the proprietary fund statements, and the fiduciary fund financial statements (trust funds only). Generally, the cumulative sum of differences between an employer's annual OPEB cost and the amounts actually contributed to the plan since the effective date of the standards makes up a liability (or asset) called the net OPEB obligation. Each proprietary fund (and, if applicable, trust fund) from which OPEB contributions are made should report its allocable portion of this liability (or asset).

8.31 Under modified accrual in the governmental fund financial statements, an employer reports OPEB expenditures equal to the amount contributed to the plan or expected to be liquidated with expendable available financial resources. Because the governmental fund financial statements focus on current financial resources, they would not include the net OPEB obligation and generally would not include any other long-term liability or asset. By contrast, for an employer government participating in a cost-sharing multiple-employer plan, the annual OPEB expense is equal to the employer's contractually required contribution to the plan—the amount assessed by the plan for the period—which may or may not equal the ARC.

8.32 Some employers receive reimbursements for a portion of their retiree health care costs through Medicare Part D and through the Early Retirement Reinsurance Program, under the Patient Protection and Affordable Care Act of 2010. As discussed in GASB Technical Bulletin 2006-1, *Accounting and Financial Reporting by Employers and OPEB Plans for Payments from the Federal Government Pursuant to the Retiree Drug Subsidy Provisions of Medicare Part D*, and GASB IG 2015-1 Z.33.26, as amended, these reimbursements should not impact the measurement of the employer's obligations or expense for OPEB. If an employer subsequently uses the proceeds to make a contribution to a plan that is administered as a qualifying OPEB plan trust (or if the reimbursing payment is made directly into the Trust), that contribution should be accounted for as an employer contribution.

8.33 In health insurance plans where a government's retirees and current employees are insured together as a group, the premiums paid by the retirees may be lower than they would have been if the retirees were insured separately. The difference is an employer contribution toward the cost of providing coverage to retirees in a form sometimes referred to as an implicit rate subsidy. Implicit rate subsidies are to be included in calculations of OPEB costs and obligations whether or not the employer also makes an additional contribution in explicit form (see paragraph 13a(2) of GASB Statement No. 45 for benefits to be included in the calculation of OPEB costs and obligations when an employer provides benefits for both retirees and current employees through the same plan).

8.34 As mentioned previously, actuarial valuations performed in accordance with parameters established by GASB in Statement No. 45, as amended, are required. However, in recognition of the potential cost of hiring consultants to perform these valuations, the standards allow the smallest single-employer plans—those with fewer than one hundred members—and the employers that participate in them to estimate the AAL and the ARC using simplified methods and assumptions (that is, referred to in GASB Statement No. 45 as the alternative measurement method). (GASB Statement No. 57, *OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans*, permits an agent employer to use an alternative measurement method if it has an individual-employer OPEB plan with fewer than 100 plan members, regardless of the number of total plan members in the agent multiple-employer OPEB plan in which it participates.) The specifics of this alternative measurement method are described fully in GASB Statement No. 45 in paragraphs 33–35.

Grants, Entitlements, and Shared Revenues, Including Appropriations to Component Units[12]

8.35 Expenses or expenditures for grants, entitlements, and shared revenues, including appropriations from a primary government to a component unit, generally meet the definitions in GASB Statement No. 33, as amended, of government-mandated or voluntary nonexchange transactions. Governments should recognize expenses and liabilities for government-mandated and voluntary nonexchange transactions when all applicable eligibility requirements—required characteristics of recipient, time requirements, reimbursements, and contingencies (for voluntary nonexchange transactions)—are met. (Chapter 6, "Revenues and Receivables," discusses those eligibility requirements.) Resources transmitted before the eligibility requirements are met, excluding time requirements, should be reported as assets by the provider, whereas resources transmitted before time requirements are met, but after all other eligibility requirements have been met, should be reported as deferred outflows of resources.

8.36 GASB Statement No. 33 paragraph 11, as amended, states that the standards in the statement apply whether the accrual basis or the modified accrual basis of accounting is required, except for the revenue recognition standards. Therefore, expenditures and liabilities for government-mandated and voluntary nonexchange transactions should be recognized in governmental funds when all applicable eligibility requirements are met. Numerous examples of the recognition of expenses from intergovernmental grants, entitlements, and shared revenues are provided in nonauthoritative appendixes to GASB Statement Nos. 33 and 36.

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[12] Paragraphs 75–79 in the "Basis for Conclusions" section of GASB Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues*, discuss that annual appropriations to pay debt issued by a component unit for which the primary government has not pledged its full faith and credit should be reported as an obligation of the primary government only when the appropriations are irrevocably pledged, that is, usually annually.

8.37 Paragraph 26 of GASB Statement No. 33 provides guidance on the contravention of provider stipulations. After a nonexchange transaction has been recognized in the financial statements, it may become apparent that (*a*) the eligibility requirements are no longer met or (*b*) the recipient will not comply with the purpose restrictions within the specified time limit. In those circumstances, if it is probable that the provider will not provide the resources or will require the recipient to return all or part of the resources already received, the recipient should recognize a decrease in assets (or an increase in liabilities) and the provider should recognize a decrease in liabilities (or an increase in assets) and a revenue for the amount that it is expected to cancel or reclaim.

8.38 Governments often receive grants and other financial assistance to transfer to or spend on behalf of secondary recipients. Those amounts are referred to as *pass-through grants*. For example, state governments often pass through federal awards for community development, education, and social services programs to other governments, not-for-profit organizations, and individuals. Recipient governments may receive fees for administering pass-through grants, which they should report as revenues. GASB Statement No. 24, *Accounting and Financial Reporting for Certain Grants and Other Financial Assistance*, as amended, requires that all cash pass-through grants received by a recipient government be reported in its financial statements. As a general rule, recipient governments should recognize cash pass-through grants as revenue and expenses or expenditures in a governmental or proprietary fund, and as revenue and expenses in the government-wide financial statements. In those infrequent cases in which a recipient government serves only as a cash conduit (as defined in GASB Statement No. 24, as amended), the grant should be reported in an agency fund, in which case it would not be reported in the government-wide financial statements. A grantor may disallow costs for pass-through grants that do not comply with its requirements. As applicable, the provisions of GASB Statement No. 33, as amended, or paragraphs 96–113 of GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, as amended, apply in determining whether to accrue refund liabilities, accrue receivables from subrecipients, or disclose contingent liabilities for disallowed costs. (See paragraphs 8.65 and 8.67.)

8.39 On-behalf payments for fringe benefits and salaries are direct payments made by one entity (the paying entity or paying government) to a third-party recipient for the employees of another, legally separate entity (the employer entity or employer government). However, the provisions of GASB Statement No. 24 do not apply to payments that are legally required to be made directly to a pension plan that (*a*) is administered through a trust that meets the criteria in GASB Statement No. 68 and (*b*) is used to provide pensions to the employees of another entity or entities. Instead refer to GASB Statement No. 68 for guidance. GASB Statement No. 24 paragraph 13, as amended, states that a paying government should classify the expenses or expenditures for the on-behalf payments that it makes in the same manner that it classifies similar cash grants to other entities. For example, if a state government classifies state aid payments to school districts as education expenditures, on-behalf payments of pension contributions for the school districts also should be classified as education expenditures, rather than as pension expenditures. (Chapter 6 discusses the revenue accounting and financial reporting for such on-behalf payments by the employer government for pensions not administered through trusts or equivalent arrangements that meet specified criteria.)

Service Concession Arrangements

8.40 GASB Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements*, as amended, establishes accounting and financial reporting standards for service concession arrangements, defined as an arrangement between a government (the transferor) and an operator, in which all of the following criteria are met:

a. The transferor conveys to the operator the right and related obligation to provide public services through the use and operation of a capital asset (a *facility*) in exchange for significant consideration, such as an upfront payment, installment payments, a new facility, or improvements to an existing facility.

b. The operator collects and is compensated by fees from third parties.

c. The transferor determines or has the ability to modify or approve what services the operator is required to provide, to whom the operator is required to provide the services, and the prices or rates that can be charged for the services (see GASB IG 2015-1 question Z.60.1 for further discussion).

d. The transferor is entitled to significant residual interest in the service utility of the facility at the end of the arrangement.

Service concession arrangements include, but are not limited to arrangements in which the operator will

a. design and build a facility and will obtain the right to collect fees from third parties (for example, construction of a municipal complex for the right to lease a portion of the facility to third parties).

b. provide significant consideration in exchange for the right to access an existing facility (for example, a parking garage) and collect fees from third parties for its usage.

c. design and build a facility for the transferor (for example, a new tollway), finance the construction costs, provide the associated services, collect the associated fees, and convey the facility to the government at the end of the arrangement.

Accounting and Financial Reporting by the Transferor

8.41 A transferor should recognize a liability for certain obligations to sacrifice financial resources under the terms of a service concession arrangement. Liabilities associated with the arrangement should be recorded at their present value if a contractual obligation is significant and meets either of the following criteria:

a. The contractual obligation directly relates to the facility (for example, the obligations for capital improvements, insurance, or maintenance of the facility). This obligation could relate to ownership of the facility or could arise from the transferor's responsibility to ensure that the facility remains fit for the particular purpose of the arrangement.

b. The contractual obligation relates to a commitment made by the transferor to maintain a minimum or specific level of service in connection with the operation of the facility (for example, providing a specific level of police and emergency services for the facility or providing a minimum level of maintenance to areas surrounding the facility).

If a liability is recorded, the liability should be reduced as the transferor's obligations are satisfied. As obligations are satisfied, a deferred inflow of resources should be reported and the related revenue should be recognized in a systematic and rational manner over the remaining term of the arrangement.

8.42 If a service concession arrangement requires upfront or installment payments from the operator, the transferor should report (*a*) the upfront payment or present value of installment payments as an asset, (*b*) any contractual obligations as liabilities, and (*c*) related deferred inflow of resources equal to the difference between (*a*) and (*b*). Revenue should be recognized as the deferred inflow of resources is reduced. This revenue should be recognized in a systematic and rational manner over the term of the arrangement. A liability should be recognized if the transferor has contractual obligations that meet the criteria described previously.

Accounting and Financial Reporting by a Governmental Operator

8.43 Some service concession arrangements require a facility to be returned in a specified condition. If information that is prominent (that is, conspicuous or known to the governmental operator) indicates the facility is not in the specified condition and the cost to restore the facility to that condition is reasonably estimable, a liability and, generally, an expense to restore the facility should be reported. Governmental operators are not required to perform additional procedures to identify potential condition deficiencies beyond those already performed as part of their normal operations or those that may be required by the agreement.

8.44 Accounting and financial reporting for various types of service concession arrangements is also discussed in chapters 7, 9, and 12.

Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues

8.45 GASB Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues*, as amended, discusses exchanges by governments of interests in their expected cash flows from collecting specific receivables or specific future revenues for immediate cash payments. The statement, as amended, provides standards for determining whether such exchanges should be classified as sales or as collateralized borrowing transactions. Liabilities can result from application of the guidance provided in GASB Statement No. 48, as amended. Such liabilities also may be required to be amortized using a systematic and rational method. See chapter 6 for a discussion of the provisions of GASB Statement No. 48, as amended.

Unrelated Business Income Taxes

8.46 Certain governmental entities are subject to federal unrelated business income taxes (UBIT), which is a tax on income derived from any trade or business that is regularly carried on and not substantially related to the organization's tax-exempt purpose or function. The governmental entities subject to UBIT are those that have received federal income tax exemptions from the IRS, such as Section 501(c)(3) corporations, as well as governmental colleges and universities and their wholly owned subsidiary corporations. As with most federal tax provisions, the provisions for UBIT can be complex. Affected governments should report expenses or expenditures and liabilities for UBIT when the liability is incurred.

Fund-Raising Costs

8.47 Some governmental entities, such as colleges and universities and health care providers, solicit support through fund-raising activities conducted in conjunction with activities related to other functions, such as program activities or supporting services. AICPA Statement of Position (SOP) 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising* (AICPA, *Professional Standards*, ACC sec. 10),[13] included as a supplement to this guide, establishes accounting and financial reporting standards for the costs of joint fund-raising and program activities. It also requires disclosures about the nature of the activities for which joint costs have been allocated and the amounts of joint costs. Although that SOP applies to all governments, its provisions are only meaningful for those governmental entities that report using related functional classifications.

Landfill Closure and Postclosure Care Costs

8.48 GASB Statement No. 18, *Accounting for Municipal Solid Waste Landfill Closure and Postclosure Care Costs*, as interpreted by GASB Interpretation No. 6, establishes standards of accounting and financial reporting for municipal solid waste landfill closure and postclosure care costs that are required to be incurred by federal, state, or local laws or regulations. GASB Statement No. 18, as interpreted, requires certain capital and operating costs that result in disbursements near or after the date that the landfill stops accepting solid waste and during the postclosure period to be included in the estimated total current cost of landfill closure and postclosure care.

8.49 In the proprietary fund and government-wide financial statements, a portion of the estimated total current cost of landfill closure and postclosure care should be recognized as an expense and liability in each period that the landfill accepts solid waste. Recognition should begin on the date the landfill begins accepting solid waste, continue in each period that it accepts waste, and be completed by the time it stops accepting waste. Estimated total current cost should be assigned to periods based on landfill use. Equipment, facilities, services, and final cover included in the estimated total current cost should reduce the accrued landfill closure and postclosure care liability when they are acquired. Using the measurement criteria discussed previously, governmental funds should recognize expenditures and related fund liabilities for landfill closure and postclosure care costs as discussed in paragraphs 8.13–.14.

8.50 Landfill owners or operators may be required to provide financial assurances for closure, postclosure care, and remediation of each landfill by placing assets with a third-party trustee or in a surety standby trust. GASB Statement No. 18 paragraph 15 states that those amounts should be reported

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[13] Statement of Position 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising* (AICPA, *Professional Standards*, ACC sec. 10), includes governmental entities in its scope and includes accounting and financial reporting guidance that was cleared by GASB, and thus contains category B guidance for governmental entities. See the discussion of the hierarchy of governmental generally accepted accounting principles (GAAP) in chapter 1, "Overview and Introduction."

in the fund used to report landfill operations and be identified by a description such as "amounts held by trustee." Investment earnings on amounts set aside to finance closure and postclosure care should be reported as revenue, not as reductions of the estimated total current cost of landfill closure and postclosure care and related accrued liability.

8.51 GASB Statement No. 18 paragraph 17, as amended, requires certain disclosures in the notes to the financial statements concerning the nature and amount of landfill closure and postclosure care costs and liabilities.

Pollution Remediation Obligations

8.52 GASB Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*, as amended, addresses accounting and financial reporting standards for pollution (including contamination) remediation obligations, which are obligations to address the current or potential detrimental effects of existing pollution by participating in pollution remediation activities such as site assessments and cleanups. The statement excludes pollution prevention or control obligations with respect to current operations. It also excludes future pollution remediation activities that are required upon retirement of an asset, such as landfill closure and postclosure care and nuclear power plant decommissioning, unless a liability has not been recorded by the time an obligating event occurs as discussed in paragraph 8.53.

8.53 When any one of five specified obligating events occurs,[14] a government is required to estimate the components of expected pollution remediation outlays and determine whether outlays for those components should be accrued as a liability or, if appropriate, capitalized (see chapter 7) when goods and services are acquired. Most pollution remediation outlays do not qualify for capitalization and should be accrued as a liability (subject to modified accrual provisions in governmental funds) and expense when a range of expected outlays is reasonably estimable or as an expenditure upon receipt of goods and services.

8.54 Calculation of the projected liability (or future capital asset, as appropriate) is based on the future cash flows, measured at their current value, that are expected to be needed to adequately remediate the pollution. GASB Statement No. 49, as amended, requires that several remediation alternatives are to be considered. The pollution remediation obligation liability (or estimated future capital asset) is the sum of the individual probability weighted alternatives. The estimated pollution remediation liability (or future capital asset) is calculated using current and applicable laws and regulations and is to be based on existing technology that is expected to be used to discharge the pollution obligation. As new information becomes available, as operating conditions change, as changes are made to the remediation plan, or as benchmarks are met, the liability (or estimated future capital asset) should be adjusted. GASB Statement No. 49, as amended, also specifies that expected recoveries from other responsible parties, and from insurance policies that indemnify a government

[14] Obligating events include (1) the government is compelled to take pollution remediation action because of an imminent endangerment; (2) the government violates a pollution prevention-related permit or license; (3) the government is named, or evidence indicates that it will be named, by a regulator as a responsible party or potentially responsible party for remediation, or as a government responsible for sharing costs; (4) the government is named, or evidence indicates that it will be named, in a lawsuit to compel participation in pollution remediation; or (5) the government commences or legally obligates itself to commence pollution remediation.

for pollution remediation obligations, should reduce the measurement of the expense and also should reduce the liability if not yet realized or realizable.

8.55 GASB Statement No. 49, as amended, requires in part, that for goods and services used for pollution remediation activities, amounts that are normally expected to be liquidated with expendable available financial resources should be recognized as governmental fund liabilities upon receipt of those goods and services. Estimated recoveries of pollution remediation outlays from insurers and other responsible parties or potentially responsible parties for which the government is performing remediation activities should reduce any associated pollution remediation expenditures when the recoveries are measurable and available.

8.56 GASB Statement No. 49, as amended, requires certain disclosures in the notes to the financial statements concerning the nature, source, and amount of pollution remediation liabilities and the methods and assumptions used for the estimate. Additional note disclosures are required for estimated recoveries and when a pollution remediation liability has not yet been recognized because it is not reasonably estimable.

Claims and Judgments: Risk Financing and Loss Contingencies

8.57 Claims and judgments include risk financing and insurance related activities, which are addressed in GASB Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, as amended; GASB Statement No. 30, *Risk Financing Omnibus—an amendment of GASB Statement No. 10*; and GASB Interpretation No. 4, *Accounting and Financial Reporting for Capitalization Contributions to Public Entity Risk Pools—an interpretation of GASB Statements No. 10 and 14*. In addition, GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*, as amended, clarifies and establishes accounting requirements for insurance recoveries. Paragraphs 7, 11, and 17 of the GASB IG 2015-1 provide additional guidance.

8.58 GASB Statement No. 10, as amended and interpreted, establishes accounting and financial reporting standards for risk financing and insurance-related activities relating to risks of loss from torts; theft of, damage to, or destruction of assets; business interruption; errors or omissions; job-related illnesses or injuries to employees; and acts of God as well as losses from providing accident and health, dental, and other medical benefits to active employees and their dependents and beneficiaries, based on covered events that have already occurred. Governments may manage and finance those risks by, for example, purchasing commercial insurance, participating in public entity risk pools, or retaining the risk. GASB Statement No. 45, as amended, amends paragraph 2 of GASB Statement No. 10 to eliminate retiree health benefits from the scope of GASB Statement No. 10. GASB IG 2015-1 question 3.50.3 further discusses this matter.

8.59 GASB Statement No. 10, as amended, provides that when an internal service fund is used, if part or all of a risk of loss has not been transferred to an unrelated third party, the government should report an estimated loss as an expense and liability in the government-wide, proprietary fund, and trust fund financial statements if two conditions are met. Those conditions are that (*a*) information available before the financial statements are issued indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements and (*b*) the amount of loss can be reasonably estimated. The estimated loss should include incurred but not reported amounts—(*a*) known loss events that are expected to later be presented as claims, (*b*) unknown loss events that are expected to become claims, and (*c*) expected future development on claims already reported—if those losses can be reasonably estimated and it is probable that a claim will be asserted. Claim liabilities should include incremental claim adjustment expenditures or expenses. Additional guidance on measuring the liability is provided in GASB Statement No. 10, as amended and interpreted. Governmental funds should recognize expenditures and related fund liabilities for those claims and judgments as discussed in paragraphs 8.13–.14.

8.60 Stand-alone entities that engage only in business-type or fiduciary activities and that are not considered to be a part of another financial reporting entity should not use an internal service fund to report their own risk financing activities.

8.61 If a government uses a governmental fund, that fund should recognize claims expenditures and liabilities as discussed for governmental funds in paragraph 8.59 (including that paragraph's reference to paragraphs 8.13–.14). The government may use any method to allocate claims expenditures to other funds, and generally should account for amounts charged to other funds from the general fund as interfund reimbursements. (Interfund reimbursements are discussed in chapter 9.) However, if the total amount charged to the other funds (including the general fund itself) exceeds the total claims expenditures and liabilities recognized, the excess amounts should be reported as interfund transfers.

8.62 If a government uses an internal service fund, that fund should recognize claims expenses and liabilities as discussed in paragraph 8.59. The total charge by the internal service fund to the other funds for the period should (*a*) equal the expense and liability recognized or (*b*) be based on an actuarial method or historical cost information and adjusted over a reasonable period of time so that internal service fund revenues and expenses are approximately equal (plus, if the government chooses to, a reasonable provision for expected future catastrophe losses). Those interfund charges should be recognized as revenue by the internal service fund and as expenses or expenditures by the other funds. Deficits, if any, in the internal service fund resulting from using method *b* do not need to be charged back to the other funds in any one year, as long as adjustments are made over a reasonable period of time. If the charge by the internal service fund to the other funds fails to recover the full cost of claims over a reasonable period of time, any deficit fund balance in the internal service fund should be charged back to the other funds and reported as expenses or expenditures of those funds. If the charge by the internal service fund to the other funds is greater than that permitted by methods *a* or *b*, the excess should be reported in both the internal service fund and the other funds as an interfund transfer.

8.63 GASB Statement No. 10, as amended and interpreted, also provides guidance on how governments should account for and report on their participation in public entity risk pools. The accounting and financial reporting requirements for public entity risk pools are discussed in chapter 12.

8.64 For insurance recoveries associated with capital asset impairment, GASB Statement No. 42 paragraph 21 requires that insurance recoveries[15] be recognized only when realized or realizable. If an insurer has admitted or acknowledged coverage, an insurance recovery would be realizable. If the insurer has denied coverage, the insurance recovery generally would not be realizable. GASB Statement No. 42, as amended, states that the governmental fund financial statements should report the insurance recovery as an other financing source or extraordinary item, as appropriate. It also states that the governmental and business-type activities in government-wide financial statements and the proprietary fund financial statements should net those insurance recoveries with the associated loss when the recovery and loss occur in the same year. GASB Statement No. 42 paragraph 22 states that insurance recoveries other than those related to impairment of capital assets, such as for theft or embezzlement of cash or other monetary assets, should be accounted for as described for insurance recoveries related to capital asset impairment. If not otherwise apparent in the financial statements, the notes to the financial statements should disclose the amount and financial statement classification of insurance recoveries.

8.65 Claims and judgments also involve loss contingencies—existing conditions that may create a legal obligation in the future but that arise from past transactions or events—resulting from all claims from actions not included in the scope of GASB Statement No. 10, as amended and interpreted (see paragraph 8.58). Those other claims include contractual actions, such as claims for delays or inadequate specifications on contracts, or for guarantees of the debt of others in an exchange or exchange-like transaction (see paragraphs 8.100–.101 for requirements related to nonexchange financial guarantees), unemployment compensation claims, and, subject to the guidance in GASB Statement No. 33, as amended, property tax appeals, tax refund claims, and refunds of nonexchange revenues when the government does not meet a provider's requirements. NCGA Statement 4, *Accounting and Financial Reporting Principles for Claims and Judgments and Compensated Absences*, as amended, and GASB Statement No. 62 paragraphs 100–104 establish the requirements for accrual of a loss contingency in these situations. Under GASB Statement No. 62 paragraph 102, a loss contingency should be accrued when (*a*) information available prior to issuance of the financial statements indicates it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements (it is implicit in this condition that it should be probable that one or more future events will occur confirming the fact of the loss) and (*b*) the amount of the loss can be reasonably estimated. Consequently, loss contingencies may involve pending, threatened, or unasserted litigation, claims, or assessments as of the financial statement date. Governmental funds should recognize expenditures and related fund liabilities for claims and judgments arising from loss contingencies as discussed in paragraphs 8.13–.14. Contingencies that might result in gains usually are not reflected in the accounts because doing so might result in the recognition of revenue prior to its realization.

8.66 Governments also may need to recognize loss contingencies and make note disclosures (including disclosure of material violations of finance-related

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[15] GASB IG 2015-1 question Z.42.11 indicates that the guidance in GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*, paragraph 21 applies to any loss covered by insurance, whether or not the policyholder is the government.

legal provisions and actions taken to address such violations) relating to noncompliance with federal tax requirements, such as those relating to employment taxes and employee benefits. Those requirements may involve, for example, Federal Insurance Contributions Act reporting and social security and Medicare coverage.

8.67 GASB Statement No. 10, as amended and interpreted, and GASB Statement No. 62 paragraphs 106–113, as amended, require the following disclosures relating to claims and judgments:

- If no accrual is made for a loss contingency because one or both of the required conditions are not met, or if an exposure to loss exists in excess of the amount accrued, disclosure of the contingency should be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred. The disclosure should indicate the nature of the contingency and an estimate of the possible loss or range of loss, or state that such an estimate cannot be made.
- Information becoming available after the date of the government's financial statements, but before the financial statements are issued, may indicate an asset was impaired or a liability was incurred after the date of the financial statements, or that there is at least a reasonable possibility that an asset was impaired or a liability was incurred after that date. When disclosure of a loss contingency resulting from such information is deemed necessary to keep the financial statements from being misleading, the financial statements should indicate the nature of the loss or loss contingency and provide an estimate of the amount or range of loss or possible loss or state that such an estimate cannot be made (GASB Statement No. 62 paragraph 108, as amended, provides guidance for disclosure of pro forma financial information related to asset impairment or the incurrence of a liability).
- Certain loss contingencies related to guarantees (for example guarantees of indebtedness of others in an exchange or exchange-like transaction and guarantees to repurchase receivables) should be disclosed in the financial statements even though the possibility of loss may be remote. The disclosure should include the nature and amount of the guarantee with consideration given to disclosing the value of any recovery that could be expected to result (for example, a guarantor's right to proceed against an outside party), if estimable.
- Adequate disclosure should be made of contingencies that might result in gains, but care should be exercised to avoid misleading implications as to the likelihood of realization.
- The entity should describe the risks of loss to which it is exposed and the way(s) in which those risks of loss are handled; significant reductions in insurance coverage from coverage in the prior year by major categories of risk; whether the amount of settlements exceeded insurance coverage for each of the past three fiscal years; and the nature of participation in risk pools, including the rights and the responsibilities of both the entity and the pool.

- If an entity retains the risk of loss, it should disclose various data about recorded and unrecorded liabilities. (See GASB Statement No. 10 paragraph 77, as amended.)
- For risk financing internal service funds, deficit net position should be disclosed and a net position that results from charging a reasonable provision for expected future catastrophe losses should be disclosed as restricted net position.

Operating Leases

8.68 Many governments enter into lease purchase agreements, installment purchase contracts, or other forms of capital asset financing agreements (collectively termed *lease agreements*). The accounting and financial reporting for lease agreements is described in NCGA Statement 5, *Accounting and Financial Reporting Principles for Lease Agreements of State and Local Governments*, as amended, GASB Statement No. 14, and GASB Statement No. 62, as amended. This chapter discusses lessee accounting and financial reporting for operating leases; chapter 7 discusses lessee accounting and financial reporting for capital leases. Chapter 6 discusses lessor accounting. Chapter 12 (in the section on financing authorities) discusses specialized standards for leases between a primary government and a component unit.

8.69 GASB Statement No. 13, *Accounting for Operating Leases with Scheduled Rent Increases*, as amended, requires that transactions arising from operating leases with scheduled rent increases be measured based on the terms of the lease contract when the pattern of the payment requirements, including the increases, is systematic and rational. However, if the pattern of the payment requirements is not systematic and rational—for example, if there is a rent reduction or "rent holiday" that constitutes a financing arrangement between the lessor and the lessee, or if there are reduced rents to induce the lessee to enter into the lease—the operating lease transactions should be measured either (*a*) on a straight-line basis over the lease term or (*b*) based on the estimated fair value of the rental. GASB Statement No. 13, as amended, contains guidance on measuring the fair value of the rental.

8.70 The government-wide and proprietary and trust fund financial statements should recognize expenses from operating leases with scheduled rent increases using the measurement criteria discussed in paragraph 8.69.[16] Governmental funds should recognize expenditures from operating leases with scheduled rent increases and report the related fund liabilities using the measurement criteria discussed in that same paragraph to the extent that the amounts are payable with expendable, available financial resources. (Note that the scope of GASB Interpretation No. 6 does not include operating leases with scheduled rent increases.)

8.71 Paragraphs 223 and 231 of GASB Statement No. 62 require governments to provide certain operating lease disclosures, including disclosures for operating leases with scheduled rent increases. NCGA Statement 1 paragraph 40 also requires disclosure of significant noncapitalized (operating) lease commitments. GASB Statement No. 38, *Certain Financial Statement Note Disclosures*, paragraph 11 requires governments to disclose the future minimum principal and interest payments for each of the five subsequent fiscal years and

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[16] If the fair value measurement is used for operating leases with scheduled rent increases, the interest portion of the expense should be recognized each period using the interest method.

in five-year increments thereafter for their obligations under capital and noncancelable operating leases.

Customer and Developer Deposits

8.72 Many electric, water, gas, sewer, and other utility operations require customer deposits to assure timely payment for services. Customer deposits to secure service payments normally are required before service starts and are refunded when service is terminated. Utility operations also may require land developers or individual property owners to make deposits as advance payments of system development fees to extend utility service lines to their properties. Utility operations generally are reported in enterprise funds, and unearned customer and developer deposits initially are recorded as liabilities in those funds and in the government-wide financial statements. Customer deposits remain as liabilities until they are applied against unpaid billings or refunded to customers. Developer deposits remain as liabilities until they are recognized as revenue from system development fees. Depending on the enabling legislation, the cash received from customers, developers, or both for deposits or advance system development fees may need to be reported as a restricted asset in the fund and government-wide financial statements. (See chapter 6.)

Expenses Resulting From Previously Incurred Disbursements

Prepaid Items

8.73 Prepaid items are payments for services, such as insurance or rent, before they are received. The government-wide, proprietary fund, and trust fund financial statements should report prepaid items as assets until the services are received and an expense is recognized. Governmental fund expenditures for services extending over more than one accounting period need not be allocated between or among accounting periods but may be accounted for as expenditures of the period of acquisition. See chapter 10 for a discussion of prepaid (and other) items and the effect on nonspendable fund balance.

8.74 GASB Interpretation No. 4 has specific provisions for reporting prepaid insurance for capitalization contributions made to form or join a public entity risk pool. GASB Statement No. 65 requires debt issuance costs, except any portion related to prepaid insurance costs, to be recognized as an expense in the period incurred. Prepaid insurance costs should be reported as an asset and recognized as an expense in a systematic and rational manner over the duration of the related debt.

Intra-Entity Sales of Future Revenues

8.75 GASB Statement No. 48, as amended, requires that a deferred outflow of resources be recognized by the transferee in an intra-entity sale of future revenues and amortized over the duration of the sale agreement. Each year a portion of the remaining balance would be recognized as an expense or expenditure. See chapters 6 and 9 of this guide for a discussion of the provisions of GASB Statement No. 48, as amended.

Inventory

8.76 Inventory is stocks of materials held for sale or use. The government-wide, proprietary fund, and fiduciary fund financial statements should report inventory items as assets until the materials are sold or used and an expense or cost of sales is recognized. Paragraphs 192–201 of GASB Statement No. 62, which apply to government-wide, proprietary fund and trust fund financial statements, provide guidance for when supplies that are held for sale or to be used directly or indirectly in the production of goods or services should be written down to the lower of cost or market. In governmental funds, inventory items may be considered expenditures either when purchased (purchases method) or when sold (consumption method). Governmental fund inventories generally are not written down from cost to lower market values unless the usability of the inventory is affected by physical deterioration or obsolescence. NCGA Statement 1 paragraph 73, as amended, requires significant amounts of governmental fund inventories to be reported in the fund balance sheet, even though they may be recognized as expenditures using the purchases method. If using the purchases method, that reporting is accomplished by recording a corresponding credit as nonspendable fund balance. (See the further discussion in chapter 10.)

8.77 Paragraph 201 of GASB Statement No. 62, which applies to business-type activities and proprietary fund financial statements, requires disclosure of the basis for stating the various classifications of inventory items and, where practicable, the method used to determine their cost (such as average cost, first-in first-out, last-in first-out, and so forth).

Liabilities

Escheat Property

8.78 Local governments often hold abandoned or unclaimed property for some period of time (often several years) before transmitting it to the state in accordance with escheat laws. GASB Statement No. 21, *Accounting for Escheat Property*, as amended, indicates that escheat property held for individuals, private organizations, or another government should be reported in a private-purpose trust fund or in an agency fund, as appropriate, or in the governmental or proprietary fund in which escheat property is otherwise reported, with a corresponding liability. As discussed in chapter 2, private-purpose trust and agency funds (like all fiduciary funds) should not be reported in the government-wide financial statements. Chapter 12 discusses state government reporting of escheat property.

Agency Funds

8.79 Agency funds do not report liabilities for amounts owing to other funds of the government. If an agency fund is used as a clearing account to distribute financial resources to other funds, those resources should be reported as assets in the appropriate funds, not as interfund balances. (See also the discussion of amounts collected for individuals, other entities, and other funds in chapter 6.)

Debt[17]

8.80 The accounting for debt generally is based on whether the debt is short-term or long-term debt, not on whether the debt is current (that is, due to

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[17] GASB Statement No. 58, *Accounting and Financial Reporting for Chapter 9 Bankruptcies*, as amended, requires governments that have petitioned for protection from creditors by filing for bankruptcy under Chapter 9 of the United States Bankruptcy Code to remeasure liabilities that are

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be paid within one year of the financial statement date) or noncurrent. Short-term debt instruments are those with original maturities of one year or less. Long-term debt instruments are those with original maturities of more than one year.

Short-Term Debt Instruments

8.81 A government's short-term debt instruments may take one of several forms:[18]

- Revenue anticipation notes usually are secured by future revenues from one or more specific sources as well as by the government's unpledged assets. For example, tax and grant anticipation notes are secured by pledges of specific future tax and grant collections, respectively.
- Bond anticipation notes (BANs) are used primarily to provide interim construction financing and usually are retired with the proceeds of long-term debt. BANs are frequently refinanced by replacement notes if the original notes mature before the long-term debt is issued. Although the issuance of the long-term debt may be delayed pending improvement in market conditions, governments usually issue long-term debt before starting construction.
- Other short-term debt instruments usually are secured only by the pledge of the full faith and credit of the government (principally its taxing power).

8.82 Short-term debt generally is reported as a liability in the government-wide financial statements and in the financial statements of the fund receiving the proceeds. (See the exception for governmental fund BANs in certain situations in paragraph 8.83.) The issuance of the debt and the repayment of debt principal affect only the financial position statements; only the interest on the debt is reported in the activity statements.[19]

Bond and Other Anticipation Notes

8.83 NCGA Interpretation 9, *Certain Fund Classifications and Balance Sheet Accounts*, as amended, provides that in certain situations, BANs are not reported in governmental funds. If all legal steps have been taken to refinance governmental fund BANs and the intent is supported by an ability to consummate refinancing the short-term notes on a long-term basis in accordance with the criteria, the BANs should not be reported in the governmental funds but only as general long-term liabilities in the governmental activities column of the government-wide statement of net position. Paragraphs 36–44 of GASB

(footnote continued)

adjusted in bankruptcy when the bankruptcy court confirms (approves) a new payment plan. The statement requires governments to remeasure accounts payable, notes, debentures and bonds, and related interest payable based on the new plan. If the new plan does not indicate whether it reduces principal or future interest payments that have not been accrued, the debt should be remeasured at the present value of the future payments using the original discount rate with the resulting gain reported at the time of the reduction. See paragraph 15.24, chapter 15, "Concluding the Audit," and GASB Statement No. 58, as amended, for additional guidance.

[18] Some governments may issue revenue and bond anticipation notes with original maturities of more than one year. Such long-term anticipation notes are accounted for in accordance with the provisions of the GASB standards discussed in paragraphs 8.86–.87.

[19] See footnote 18.

Statement No. 62, as amended, require that bond, tax, and revenue anticipation notes of government-wide and proprietary funds be reported as current or long-term liabilities depending on the refinancing status. If a short-term obligation is excluded from fund or current liabilities, the notes to the financial statements should describe the financing agreement and the terms of any new obligation incurred or expected to be incurred as a result of a refinancing.

8.84 NCGA Interpretation 9, as amended, also requires that tax and revenue anticipation notes be reported as a liability in the governmental fund receiving the proceeds. This requirement is without regard to whether the tax and revenue anticipation notes are short- or long-term instruments.

Long-Term Debt Instruments

8.85 A government's long-term bonded debt instruments generally take one of two forms:[20]

- General obligation bonds pledge the full faith and credit of the government to pay debt principal and interest.
- Revenue (or limited-liability) bonds pledge specific receipts (such as gasoline taxes, special assessments, utility revenues, and highway or bridge tolls) to pay debt principal and interest. Revenue bonds include tax-increment bonds, which sometimes are issued in connection with economic development projects where future property tax revenues to be generated by new development are pledged to pay for the obligations issued. Revenue bonds also include bonds that are issued by governments, often financing authorities, to finance equipment or facilities that are leased to another entity. The lease payments are pledged to pay the debt principal and interest. Sometimes, lease-backed revenue bonds are issued in a form known as certificates of participation (COPs). (See the discussion of the accounting for lease-backed bonds in the section on financing authorities in chapter 12.) Depending on the expectations for future revenues, or to improve the market for or lower the interest rate on the debt, governments also may pledge their full faith and credit on revenue bonds.

8.86 NCGA Statement 1 provides that liabilities arising from long-term debt that is directly related to and expected to be paid from proprietary funds should be reported in the proprietary fund and government-wide financial position statements. (This includes general obligation bonds that are expected to be retired from proprietary fund revenues.) Liabilities arising from long-term debt that is directly related to and expected to be paid from trust funds should be reported only in the statement of trust net position. The accounting for long-term proprietary and trust fund debt is the same as for short-term debt; see paragraph 8.84.

8.87 All other unmatured liabilities arising from long-term debt are general long-term liabilities. Those liabilities should not be reported as liabilities in governmental funds but should be reported in the government-wide statement of net position, typically in the governmental activities column. Matured

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[20] Some state and local laws also may define capital leases as long-term debt instruments for purposes such as debt limitations. Chapter 7 discusses lessee accounting and financial reporting for capital leases.

but unpaid portions of general long-term debt should be reported as liabilities in both the governmental fund and government-wide financial statements. The accounting for general long-term debt that is reported in the government-wide financial statements is the same as for short-term debt; see paragraph 8.84.

8.88 In the governmental funds, except for certain demand bonds as discussed in paragraph 8.90, the face amount of long-term debt issuances is reported as an other financing source in the fund that receives the debt proceeds. Debt issuance premiums and discounts should be reported as other financing sources and uses, respectively, and debt issue costs (regardless of whether paid out of debt proceeds), such as underwriter fees, should be reported as expenditures.

8.89 Expenditures for the payment of principal and interest on general long-term debt are reported when the payments are due (matured). In addition, debt service expenditures may be reported if a government has provided financial resources to a debt service fund for payment of debt that will mature early in the following year. A government has "provided" financial resources to a debt service fund if it has deposited in or transferred to that fund financial resources that are dedicated for payment of debt service. *Early in the following year* refers to a short time period—usually one to several days and not more than one month. Debt service activities should be reported in debt service funds if those funds are legally mandated or if financial resources are being accumulated for principal and interest payments maturing in future years. Legal mandates may arise from bond agreements requiring a *reserve fund* to accumulate debt service resources or from voter approvals to issue the debt and to pay the debt through a separate tax levy. (Such reserve funds are more appropriately described as *accounts* rather than as *funds*.)[21] Many governments establish individual debt service funds for each debt issue, even though not required by legal or contractual provisions or generally accepted accounting principles (GAAP). However, some governments combine individual debt service funds into a single debt service fund for financial reporting purposes.

Demand Bonds

8.90 Demand bonds are debt issuances that give the bondholder the right to require the issuer or its agent to redeem the bonds within a certain period after giving notice, creating a potential call on current resources. GASB Interpretation No. 1, *Demand Bonds Issued by State and Local Governmental Entities—an interpretation of NCGA Statement 1 and NCGA Interpretation 9*, as amended, provides guidance for bonds that have demand provisions that can be exercised at the date of the financial statements or within one year thereafter. Those bonds should be reported as general long-term liabilities (and reported only in the government-wide statement of net position, but not in the governmental funds balance sheet) or excluded from current liabilities of proprietary funds only if all of four conditions specified in GASB Interpretation No. 1, as amended, are met. Those conditions ensure that any bonds for which demand provisions are exercised will not require the current use of the government's resources. Unless those conditions are met, demand bonds should be reported as liabilities in governmental funds or, in the case of proprietary funds, as current liabilities. GASB Interpretation No. 1 paragraph 11 requires certain note disclosures about demand bond programs, liquidity agreements,

[21] Chapter 2, "Financial Reporting," discusses whether legal or contractual provisions require the use of separate funds for financial reporting purposes.

take out agreements, and the debt service requirements that would result if the take out agreement were to be exercised.

Special Assessment Debt

8.91 Special assessment debt is a long-term obligation for which assessments levied against the benefiting properties are the primary source of repayment. Sometimes a government pays a portion of the cost of an improvement, in recognition of a "public benefit" resulting from the project. A government may be obligated in some manner to provide resources for repayment of special assessment debt in the event of default by the assessed property owners.

8.92 GASB Statement No. 6, *Accounting and Financial Reporting for Special Assessments*, as amended, provides the accounting and financial reporting standards for special assessment projects, which differ depending on whether the government is obligated in some manner to assume the payment of related debt service in the event of default by the property owners. A government is obligated in some manner for special assessment debt if (*a*) it is legally obligated to assume all or part of the debt in the event of default or (*b*) the government may take certain actions to assume secondary liability for all or part of the debt—and the government takes, or has given indications that it will take, those actions. GASB Statement No. 6, as amended, provides additional guidance on the "obligated in some manner" criterion.

8.93 If a government is obligated in some manner for special assessment debt, all transactions related to capital improvements financed by special assessments should be reported in the same manner, and on the same basis of accounting, as any other capital improvement and financing transaction. Depending on the administration of a special assessment project and the fund that is expected to pay the government's share of the project debt, if any, the transactions may be reported using proprietary or governmental funds and accounted for as discussed in paragraphs 8.86–.88, respectively.

8.94 GASB Statement No. 6, as amended, provides that if the government is not obligated in any manner for special assessment debt, the debt is not reported in the government's financial statements, and transactions of the debt service phase are reported in an agency fund. If the construction phase of the project is reported in a capital projects or other governmental fund, the source of funds is reported as revenue and identified by a description other than "bond proceeds," such as "contribution from property owners." If the project is reported in a proprietary fund, an amount equal to the amount capitalized in the fund (for the capital asset) should be reported on the accrual basis after nonoperating revenue and identified by a description such as "contribution from property owners." In the government-wide financial statements, program revenue (capital grants and contributions) equal to the amount capitalized (for the capital asset) should be reported.

8.95 GASB Statement No. 6 paragraphs 20–21 provide disclosure requirements for special assessment debt. If the government is obligated in some manner for special assessment debt, it should disclose the information required for long-term debt (see the section in this chapter titled "Disclosures"). The government also should describe the nature of its obligation, including identifying any guarantee, reserve, or sinking fund established to cover defaults by property owners. If the government is not obligated in any manner for special assessment debt, the notes should disclose the amount of the debt outstanding and the fact that the government is in no way liable for repayment.

Conduit Debt

8.96 Governments sometimes issue conduit debt, which is certain limited-obligation revenue bonds, COPs, or similar debt instruments to provide capital financing for a specific third party that is not a part of the issuer's financial reporting entity. Although conduit debt instruments bear the name of the governmental issuer, the issuer has no obligation for the debt beyond the resources provided by a lease or loan with the benefiting third party. The proceeds from the sale of such debt usually advance or achieve some public purpose, such as hospital construction or the expansion of a private business to increase employment or the government's tax base. Normally, such debt is repayable only by the benefiting third party. Conduit debt explicitly states that the government has no obligation other than possibly to help creditors exercise their rights in the event of default.

8.97 Some governments report conduit debt as liabilities in their financial statements whereas other governments do not. GASB Interpretation No. 2, *Disclosure of Conduit Debt Obligations—an interpretation of NCGA Statement 1*, does not establish accounting standards for conduit debt. However, it does state that some conduit debt issuers report the obligations as liabilities and that the interpretation does not alter that reporting or the reporting of future, substantially similar conduit debt obligations. GASB Interpretation No. 2, as amended, requires governments with conduit debt obligations to disclose a general description of the conduit debt transactions, the aggregate amount of all conduit debt obligations outstanding at the financial statement date, and a clear indication that it has no obligation for the debt beyond the resources provided by related leases or loans. See the further discussion of conduit debt obligations in the section on financing authorities in chapter 12.

Financial Guarantees

Debt Guarantees

8.98 Some governments may be legally or morally obligated for the debt of other entities. A legal obligation would be one in which one government has—through law or contract—agreed to pay the debt of another entity should the other entity be unable to do so. On the other hand, a moral obligation is usually unenforceable unless authorization to pay is adopted by the entity's governing body. An example is debt issued by a local government for which the state government is obligated, in the event of default, to consider assuming responsibility for total repayment or to consider annually the need to provide the required debt service payments. For guarantees arising from obligations to pay the debt of other entities in exchange or exchange-like transactions (except for special assessment debt as discussed in paragraphs 8.91–.94), governments should apply the requirements of NCGA Statement 4, as amended and interpreted, and GASB Statement No. 62 paragraphs 96–113 as amended. (See paragraph 8.65.) GASB Statement No. 70, *Accounting and Financial Reporting for Nonexchange Financial Guarantees*, addresses the requirements for nonexchange financial guarantees. (See paragraphs 8.69–.70.) In addition, GAAP requires the disclosure of significant commitments. (See paragraph 8.105.)

8.99 GASB Statement No. 48 paragraphs 75–79, in the "Basis for Conclusions" section of the statement, discusses pledges of revenues between a primary government and a debt-issuing component unit. If the debt of the component unit is to be paid generally through revenues generated by the primary government, such as general tax revenues from a state to pay bonded debt related to dormitories constructed for its university component unit, and is not considered guarantees of the component unit's debt, then the primary government does not recognize a liability for that debt directly. However, it will recognize a liability to its component unit when it has agreed to pay over a portion of its revenue stream for that purpose, perhaps yearly.

Nonexchange Financial Guarantees

8.100 GASB Statement No. 70 applies to governmental entities that enter into nonexchange financial guarantees in which they extend or receive financial guarantees on obligations of other entities without receiving or paying equivalent value for the guarantees. The statement establishes accounting standards for the recognition, measurement and disclosures of nonexchange financial guarantees.

8.101 The guarantor should recognize a liability when qualitative factors and historical data, if any, indicate it is more likely than not that payment will be required. The liability should be measured at the best estimate of the discounted present value of the future outflows expected to be incurred. If an estimate cannot reasonably be determined but there is a range, the liability should be measured at the minimum amount of that range. An entity legally released as an obligor in a nonexchange financial guarantee should recognize revenue.

Advance and Current Refundings and In-Substance Defeasances

8.102 GASB Statement No. 7, *Advance Refundings Resulting in Defeasance of Debt*, as amended, and No. 23, *Accounting and Financial Reporting for Refundings of Debt Reported by Proprietary Activities*, as amended, provide guidance on the accounting and financial reporting for advance and current refundings that result in the defeasance of debt. In a refunding, a government issues new debt to finance the repayment of previously issued (old) debt. The repayment of the old debt may either be immediate (a current refunding) or at some future time (an advance refunding).

8.103 An advance refunding may defease the old debt, either legally or in-substance. A legal defeasance occurs when debt is legally satisfied based on certain provisions in the debt instrument even though the debt is not actually paid. Debt is defeased in substance if the government irrevocably places cash or other assets with an escrow agent in a trust to be used solely to satisfy scheduled interest and principal payments of the debt, and the possibility that the government will be required to make future payments on that debt is remote. (See the criteria for an in-substance defeasance in GASB Statement No. 7 paragraph 4.) When debt is defeased using proceeds of new debt, neither the liability for the old debt nor the escrowed assets related to it are reported in the financial statements. Only the new debt is reported:

- For current and advance refundings that defease general long-term debt, the face amount of the new debt should be reported as an "other financing source—proceeds of refunding bonds" in the governmental fund receiving the proceeds.
- For current refundings that defease general long-term debt, payments to the escrow agent from resources provided by new debt should be reported as an "other financing use—payment to refunded bond escrow agent."

- For advance refundings that defease general long-term debt, the accounting treatment is the same for such payments in current refundings.
- Payments to the escrow agent from other resources should be reported as debt service expenditures.
- For current and advance refundings resulting in defeasance of debt reported by governmental activities, business-type activities, and proprietary funds, GASB Statement No. 23, as amended, requires that the difference between the reacquisition price and the net carrying amount of the old debt, together with any difference from prior refunding if applicable, be reported as a deferred outflow of resources or a deferred inflow of resources and recognized as a component of interest expense in a systematic and rational manner over the remaining life of the old debt or the life of the new debt, whichever is shorter. GASB Statement No. 23, as amended, provides additional standards for debt that refunds previous refunding debt.

8.104 In all periods following an advance refunding for which debt that was defeased in substance remains outstanding, governments should disclose the outstanding amount of that debt, if any, at the financial statement date. In addition, GASB Statement Nos. 7 and 23, as amended, require the following disclosures in the year of the (current or advanced) refunding: (*a*) a general description of the transaction, (*b*) the difference between the cash flows required to service the old debt and the cash flows required to service the new debt and complete the refunding, and (*c*) the economic gain or loss resulting from the transaction. GASB Statement No. 7, as amended, provides guidance on the various measures needed for those disclosures.

Commitments

8.105 Governments are subject to various commitments. Commitments are existing arrangements to enter into future transactions or events, such as long-term contractual obligations with suppliers for future purchases at specified prices and sometimes at specified quantities. NCGA Interpretation 6, *Notes to the Financial Statements Disclosure*, paragraph 4, as amended, requires note disclosure about construction and other significant commitments. (See also chapters 10 and 11 concerning the reporting of encumbrances, which are commitments against the government's appropriations for unperformed contracts for services and undelivered goods.)

Activity Statement Classifications

Government-Wide Statement of Activities

8.106 As discussed in chapter 2, the government-wide statement of activities presents activities accounted for in governmental funds by function, and activities accounted for in enterprise fund by different identifiable activities. (GASB Statement No. 34, as amended, and this guide use the term *function* to refer to the level of detail presented in the statement of activities for both governmental and business-type activities.) GASB Statement No. 34, as amended, requires resource outflows from other than transfers—expenses in this case—to be classified by function except those that meet the definition of special or extraordinary items (as discussed in paragraph 8.108). At a minimum, governments should report direct expenses for each function.[22] Direct expenses are those that are specifically associated with a service, program, or department and, thus, clearly identifiable to a particular function. (Paragraph 13 of the GASB IG 2015-1 provides additional guidance for identifying direct expenses.) Some functions (such as general government, support services, or administration) include expenses that are, in essence, indirect expenses of other functions. Although governments are not required to allocate those indirect expenses among other functions, they may allocate some or all of them. If indirect expenses are allocated, direct and indirect expenses should be presented in separate columns in the statement of activities. A column totaling direct and indirect expenses may be presented but is not required. (See the discussion in chapter 9 about the requirement to eliminate allocations of overhead and similar expenses.)

8.107 GASB Statement No. 34, as amended, also provides classification standards for expenses for depreciation on general long-term capital assets and interest on general long-term liabilities. Chapter 7 discusses those classifications for depreciation expense. Interest on general long-term liabilities should be reported as an indirect expense except in those limited instances when borrowing is essential to the creation or continuing existence of a program and it would be misleading to exclude the interest from direct expenses of that program (for example, a new program that is highly leveraged in its early stages). Most interest on general long-term liabilities should be reported in the statement of activities as a separate line that clearly indicates that it excludes direct interest expenses, if any, reported in other functions. The amount excluded should be disclosed in the notes or presented on the face of the statement.

8.108 Special items are transactions or other events within the control of management that are either unusual in nature or infrequent in occurrence. Paragraphs 46–48 of GASB Statement No. 62 define the terms *unusual in nature* and *infrequency of occurrence*. Extraordinary items are transactions or other events that are both unusual in nature and infrequent in occurrence. Special items should be reported before extraordinary items. GASB IG 2015-1 question 7.43.2 provides the following examples of items that may be special items:

- Sales of certain general governmental capital assets
- Termination benefits resulting from workforce reductions due to sale of utility operations
- Early retirement program offered to all employees
- Significant forgiveness of debt
- Gains or loss on the disposal of government operations
- Net position received or assumed by a continuing government in a transfer of operations

It also provides the following examples of items that may be extraordinary items:

- Costs related to an environmental disaster caused by a large chemical spill in a train derailment in a small city

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[22] As discussed in chapter 2, GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, as amended, encourages governments to provide data in the statement of activities at a more detailed level than by function if doing so provides more useful information without significantly reducing the statement's understandability.

- Significant damage to the community or destruction of government facilities by a terrorist act or a natural disaster such as a tornado, hurricane, flood, earthquake (note that the geographic location of the government may determine if a weather-related natural disaster is infrequent)
- Large bequest to a small government by a private citizen

Governmental Funds Statement of Revenues, Expenditures, and Changes in Fund Balances

8.109 In the governmental funds, resource outflows from other than transfers should be reported as expenditures, classified at a minimum by function, unless they are required to be reported as other financing uses, special items, or extraordinary items. Expenditures also should be classified by character, that is, on the basis of the fiscal period they are presumed to benefit. The major character classifications of expenditures are *current*, which benefit the current fiscal period; *capital outlays*, which are presumed to benefit both the present and future fiscal periods; *debt service*, which presumably benefits prior fiscal periods as well as current and future periods; and *intergovernmental*, where one government transfers resources to another.

8.110 Other financing uses, which should be reported with other financing sources after the excess (deficiency) of revenues over expenditures, should include long-term debt issuance discounts (see paragraph 8.88) and payments to escrow agents for bond refundings paid from resources provided by the new debt (see paragraph 8.103). Special and extraordinary items (see paragraph 8.108) should be reported separately after other financing sources and uses. If both special and extraordinary items occur during the same period, they should be reported separately within a special and extraordinary items classification.

Proprietary Funds Statement of Revenues, Expenses, and Changes in Fund Net Position

8.111 In the proprietary funds, resource outflows from other than transfers are classified as operating expenses, nonoperating expenses, special items, or extraordinary items. Chapter 6 discusses requirements of GASB Statement No. 34, as amended, for defining operating revenues and expenses. Paragraph 8.108 discusses special and extraordinary items. Operating and nonoperating expenses should be detailed. GASB IG 2015-1 question 7.72.4 indicates that the required detail may be provided by using natural classifications (for example, salaries and wages, employee benefits, supplies, utilities) or functions (a public university, for example, may use instruction, academic support, student services, and so forth).

Trust Funds Statement of Changes in Trust Net Position

8.112 This statement reports only trust funds; agency funds should not be reported in this statement. Resource outflows are classified as deductions. The detailed display requirements of GASB Statement Nos. 67 and No. 74, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, apply to the statements of changes in fiduciary net position for employee benefit trust funds used to report pensions and OPEB administered through a trust or equivalent arrangement that meets the specified criteria. See chapter 13, which discusses GASB Statement No. 67, and chapter 14, which discusses GASB Statement No. 74.

8.113 Agency fund activities are reported in a statement of changes in assets and liabilities that may be presented as supplementary information (SI) other than RSI, referred to in this guide as "*GASB defined*" *SI* (for example, in the combining and individual fund financial statements in a comprehensive annual financial report).[23] That statement presents changes in all assets and liabilities, not only cash transactions. (Chapters 4 and 16, "Audit Reporting," discuss the auditor's responsibility and reporting on "GASB defined" SI.)

Financial Position Statement Classifications

8.114 GASB Statement No. 34, as amended, requires the government-wide statement of net position to present assets and liabilities in order of liquidity (which is encouraged) or classified between current and long-term. It also requires assets and liabilities of proprietary funds to be classified between current and long-term. Chapter 2 discusses the requirements for those presentations. The detailed display requirements of GASB Statement Nos. 67, as amended, and 74 apply to the statements of plan net position of pension trust funds and OPEB trust funds, respectively. See chapter 13, which discusses GASB Statement No. 67 and chapter 14, which discusses GASB Statement No. 74.

8.115 If proprietary or trust fund liabilities for which the government is contingently liable are in default—or if it is probable that those liabilities will not be paid on a timely basis from the resources of those funds and default is imminent—NCGA Statement 1 paragraph 46, as amended, requires the liabilities to be reported separately from other liabilities in the fund balance sheet and in the government-wide statement of net position. The notes to the financial statements should disclose all significant facts with respect to the situation.

Disclosures

8.116 Earlier portions of this chapter discuss many of the disclosures required for transactions and balances discussed in this chapter. Other required disclosures include

- the accounting principles used for recognizing expenses or expenditures (NCGA Statement 1 paragraph 70, as amended, and GASB Statement No. 62 paragraph 90–95).
- material violations of finance-related legal and contractual provisions and actions taken to address such violations (NCGA Statement 1 paragraph 158, as amended, and GASB Statement No. 38 paragraph 9).
- the government's policy for allocating indirect expenses to functions in the government-wide statement of activities (GASB Statement No. 34 paragraph 115, as amended).
- the government's policy for whether it first applies restricted or unrestricted resources when an expense is incurred for purposes for which both restricted and unrestricted components of net position are available (GASB Statement No. 34 paragraph 115, as amended).

[23] This guide uses the term "*GASB defined*" *SI* to refer to supplementary information other than RSI. See chapter 2 for more information.

- short-term debt activity during the year, including a schedule of changes in that debt and the purpose for which the debt was issued (GASB Statement No. 38 paragraph 12).
- significant effects of subsequent events (GASB Statement No. 56, *Codification of Accounting and Financial Reporting Guidance Contained in the AICPA Statements on Auditing Standards*, paragraphs 8–15, as amended).
- debt service requirements to maturity, presenting principal and interest requirements separately for each of the five subsequent fiscal years and in five-year increments after that (NCGA Statement 1 paragraph 158, as amended, and GASB Statement No. 38 paragraph 10). Note that interest requirements for variable-rate debt should be calculated using the rate in effect at the financial statement date. Note also that when derivatives are entered into to achieve a synthetic interest rate, the net cash flow should be disclosed in addition to the debt service requirements of the associated debt (GASB Statement No. 53 paragraph 74).
- the terms by which interest rates change for variable-rate debt (GASB Statement No. 38 paragraph 10).
- details about payables aggregated in the financial statements when those aggregations obscure significant components of the payables (GASB Statement No. 38 paragraph 13, as amended).
- for governments that have filed for bankruptcy (see chapter 15 of this guide for further discussion):
  - — the aggregate gain expected to occur by remeasuring liabilities subject to a proposed Plan of Adjustment, or realized, as appropriate; or a statement that any gain is not yet reasonably estimable and the reasons therefore (GASB Statement No. 58, *Accounting and Financial Reporting for Chapter 9 Bankruptcies*, paragraph 15).
  - — contingent claims not subject to reasonable estimation, based on the provisions of NCGA Statement 4 (GASB Statement No. 58 paragraph 15).

8.117 Paragraphs 116 and 119 of GASB Statement No. 34, as amended, require governments to provide the following details in the notes to the financial statements about the primary government's long-term liabilities (both long-term debt and other long-term liabilities). The information in the disclosure should be divided into major classes of long-term liabilities as well as between type of activity (governmental versus business-type):

- Beginning- and end-of-year balances
- Increases and decreases (separately)
- The portions of each item that are due within one year of the financial statement date
- Which governmental funds typically have been used to liquidate other long-term liabilities (such as compensated absences, pension liabilities, OPEB) in prior years

8.118 GASB Statement No. 34, as amended by GASB Statement No. 37, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Omnibus* also requires the disclosure of certain segment information for governments that report enterprise funds or that use enterprise fund accounting and reporting standards to report their activities. For purposes of that disclosure, a segment is an identifiable activity (or grouping of activities) reported as or within an enterprise fund or an other stand-alone entity that has one or more bonds or other debt instruments outstanding, with a revenue stream pledged in support of that debt and an externally-imposed requirement for the activity's revenues, expenses, gains and losses, assets, and liabilities to be accounted for separately. However, segment disclosures are not required (*a*) for an activity whose only outstanding debt is conduit debt for which the government has no obligation beyond the resources provided by related leases or loans or (*b*) when an individual fund is both a segment and reported as a major fund.[24] GASB Statement No. 34 paragraph 122, as amended, contains the required segment disclosures, which should be met by providing condensed financial statements in the notes to the financial statements and describing the types of goods and services provided. GASB Statement No. 34 paragraph 123 encourages governments that want to present disaggregated data for their multiple-function enterprise funds beyond what is required for segment reporting (for example, net program cost information) to present a statement of activities as "GASB defined" SI.

Management's Discussion and Analysis

8.119 As discussed in chapter 2, GASB Statement No. 34, as amended, requires the presentation of a management's discussion and analysis (MD&A) as RSI.[25] One of the requirements for presentation in MD&A is long-term debt activity during the year, including a discussion of commitments made for capital expenditures, changes in credit ratings and debt limitations that may affect the financing of planned facilities or services. As an alternative, governments may summarize in the MD&A the information in the note disclosure discussed in paragraph 8.117 and refer to that disclosure for additional details.

8.120 MD&A also should include a description of currently known facts, decisions, or conditions that are expected to have a significant effect on financial position or results of operations. According to GASB IG 2015-1 question 7.5.13 examples of currently known facts, decisions, or conditions related to expenses or expenditures and liabilities that might be expected to have a significant effect on financial position or results of operations are: the adjudication of a significant lawsuit, a flood that caused significant damage to a government's infrastructure, and a renegotiated labor contract with government employees.

Auditing Considerations

8.121 The audit objectives for the expenses or expenditures, liabilities, and deferred outflows of resources of each opinion unit, categorized by financial statement assertion, are as follows:

- *Assertions about classes of transactions and events for the period under audit*:

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[24] GASB IG 2015-1 question 7.86.2 explains that common segments should not be grouped for purposes of the disclosure.

[25] Chapters 4 and 16 discuss the auditor's responsibility for and reporting on RSI.

- — *Occurrence.* Reported expenses or expenditures represent amounts relating to the period and pertain to the government.
- — *Completeness.* The financial statements report all expenses or expenditures relating to the period.
- — *Accuracy.* Amounts and other data relating to expenditures or expenses have been recorded appropriately.
- — *Cutoff.* Expenses or expenditures have been recorded in the correct accounting period.
- — *Classification.* Expenses or expenditures have been recorded in the proper accounts.

- *Assertions about account balances at the period end*:
  - — *Existence.* Reported liabilities represent amounts unpaid as of the end of the period.
  - — *Rights and obligations.* The financial statements properly reflect conditions and agreements that affect the government's liabilities as of the end of the period.
  - — *Completeness.* The financial statements report all liabilities and deferred outflows of resources as of the end of the period.
  - — *Valuation and allocation.* Liabilities and deferred outflows of resources are reported at the appropriate amounts.
- *Assertions about presentation and disclosure*:
  - — *Occurrence and rights and obligations.* Disclosed liabilities, deferred outflows of resources, and expenditures or expenses have occurred and pertain to the entity.
  - — *Completeness.* All disclosures pertaining to expenditures or expenses, liabilities, and deferred outflows of resources that should have been included in the financial statements have been included.
  - — *Classification and understandability.* Financial information related to liabilities, deferred outflows of resources, and expenditures or expenses is appropriately presented and described and disclosures are clearly expressed.
  - — *Accuracy and valuation.* Liability, deferred outflows of resources, and expenditures or expenses information is disclosed fairly and at appropriate amounts.

8.122 The auditor might determine the various types of expenses or expenditures and liabilities that a government has by, for example, reading documents that contain legal and contractual provisions, such as budgets, enabling legislation, and grant agreements; reading minutes of the meetings of the governing body and its boards, committees, or commissions; asking appropriate officials about functions, programs, and resource use; and reviewing the financial statements of the prior period and the draft financial statements or other accounting information for the current period. The auditor should obtain an understanding of the government's internal control relevant to the audit, including controls over expenses or expenditures and liabilities. After identifying the nature and amounts of these accounts, the auditor should obtain an understanding of relevant controls over pertinent processes such as purchasing and payroll, accounting for expenses or expenditures and liabilities, and making cash disbursements. When obtaining an understanding of controls that are relevant to the audit, the auditor should evaluate the design of those controls and determine whether they have been implemented by performing procedures in addition to the inquiry of the entity's personnel.

8.123 The auditor should consider the possibility of the decentralization of the entity's purchasing and payroll, accounting, or disbursement activities and, if necessary, perform procedures to identify the various locations that conduct such activities to assess control risk at each location that may materially affect the financial statement assertions. If a service organization is used (for example, in connection with the entity's purchasing and payroll, accounting, or disbursement activities), AU-C section 402, *Audit Considerations Relating to an Entity Using a Service Organization* (AICPA, *Professional Standards*), provides requirements and guidance on the factors auditors (referred to as user auditors) should consider when auditing financial statements of an entity that uses a service organization to process certain transactions. The AICPA Guide *Service Organizations—Reporting on Controls at a Service Organization Relevant to User Entities' Internal Control Over Financial Reporting*, and AT-C section 320, *Reporting on an Examination of Controls at a Service Organization Relevant to User Entities' Internal Control Over Financial Reporting* (AICPA, *Professional Standards*), provide guidance for independent auditors (service auditors) who issue reports on processing of transactions by service organizations for other auditors.

8.124 The extent of a government's internal control usually will not be the same for all types of transactions, and consequently neither is control risk. For example, a government may have more stringent controls over its payroll and payroll-related transactions (which usually is a significant cost for governments) than it does over its contracts for goods and services (which may not be as large a cost). Sometimes, increased controls are a result of the government's budgetary system. In designing an efficient and effective approach to the audit of expenses or expenditures and liabilities, the auditor should consider the differing levels of internal control and control risk for different types of costs.

8.125 As explained in chapter 11, even though a government's budgetary comparison information may not be audited, an auditor may perform audit procedures relating to the budget to consider, for example, controls to ensure that expenses or expenditures have been properly approved, monitored and enforced, and classified within the accounts and thus assist in the audit of those items. Unlike private-sector budgets, governmental budgets typically have the force of law, are integrated into the government's accounting structure, and are an integral part of the government's internal controls. The auditor should obtain an understanding of the relevant controls to evaluate their design and determine whether they have been implemented. If the auditor determines that those budgetary controls are in place and functioning properly, the auditor may be able to assess control risk for expenses or expenditures at low to moderate and use those controls as a basis for designing the nature, timing, and extent of substantive procedures on expenses or expenditures.

8.126 A significant concern in auditing a government's financial statements is evaluating whether the entity has complied with the eligibility requirements, purpose restrictions, and other requirements in laws and contracts that could have a direct and material effect on the determination of financial statement amounts. Further, the auditor should determine that adequate procedures are performed related to the activity and balances of each of those opinion units with material expenses or expenditures and liabilities. (See the discussion of opinion units in chapter 4.)

8.127 The auditor should obtain an understanding of the government's controls over expenses or expenditures and liabilities that are relevant to the audit and should evaluate the design of those controls and determine if they have been implemented by performing procedures in addition to the inquiry of the entity's personnel. In addition to standard internal control features for those accounts, features that are unique or significant in government may include the following:

- Policies and procedures to ensure that the goods and services (including employee services) acquired and the related cash disbursements conform to legal and contractual provisions
- Processes to monitor that the government complies with the eligibility requirements, purpose restrictions, and other compliance requirements of intergovernmental grants and entitlements and private contributions
- Policies for first applying restricted or unrestricted resources when an expense is incurred for purposes for which both restricted and unrestricted components of net position are available, and procedures to ensure that policy is consistently applied
- Policies and procedures to appropriately allocate grant funds to recipients and subrecipients, to define compliance requirements and to communicate those requirements to recipients and subrecipients, and to monitor recipient and subrecipient activities on a timely basis
- Policies and procedures to ensure that debt issuances comply with legal and contractual provisions, including debt covenants
- Policies and procedures for recognizing expenses or expenditures and liabilities for UBIT
- Policies and procedures to record encumbrances for contracts and purchase orders
- Policies and procedures to ensure the proper use of petty cash and debit or procurement cards for small or routine purchases
- The review of long-outstanding checks for propriety and the escheatment of abandoned and unclaimed funds that arise from long-outstanding checks
- Policies and procedures to ensure that expenses or expenditures, prepaid items and inventory, deferred outflows of resources, liabilities, debt issuances, and commitments are measured, presented, and disclosed in the financial statements in accordance with GAAP, including processes to ensure that expenses or expenditures are properly classified, as appropriate, by fund, function, object, character, and operating or nonoperating designations; that special and extraordinary items are separately identified; and that liabilities, including debt, are reported in the proper fund

and financial statements and properly classified as to liquidity or between current and long-term

8.128 In addition to standard audit procedures for expenses or expenditures, liabilities, and deferred outflows of resources, procedures that are unique or significant in government may include the following:

- Examining a sample of expenses or expenditures to determine whether the goods and services acquired and the related cash disbursements conform to compliance requirements that could have a direct and material effect on the determination of financial statement amounts; the entity adheres to its policy concerning first applying restricted or unrestricted resources when an expense is incurred for purposes for which both restricted and unrestricted components of net position are available; and expenses or expenditures, prepaid items and inventory, and liabilities are properly recorded and classified in the accounting records
- Examining a sample of intergovernmental grants and entitlements and private contributions to determine whether the entity complies with award eligibility requirements, purpose restrictions, and other compliance requirements (such as those relating to subrecipients) that could have a direct and material effect on the determination of financial statement amounts
- Examining a sample of debt issuances to determine whether they comply with compliance requirements that could have a direct and material effect on the determination of financial statement amounts and that taxes levied or other revenues dedicated to service the debt are adequate
- Making inquiries of responsible officials and reviewing correspondence from grantor agencies, oversight or cognizant agencies, external governmental regulators, other contributors, bond trustees, and so forth for noncompliance with legal and contractual provisions and for unrecorded and unreported contingencies
- Evaluating whether the entity has properly recorded expenses or expenditures and liabilities for UBIT
- Determining whether year-end encumbrances are appropriately recorded for outstanding contracts and purchase orders, and that recorded encumbrances are valid[26]
- Examining a sample of petty cash, debit card, or procurement card purchases for propriety and documentation
- Determining that the government has appropriately reversed long-outstanding checks and that such abandoned or unclaimed amounts have been handled properly in accordance with state escheat laws
- Determining whether the entity's expenses or expenditures, prepaid items and inventory, liabilities, deferred outflows of resources, debt issuances, and commitments are measured, presented, and disclosed in the financial statements in accordance with GAAP

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[26] See chapter 10 for information related to encumbrances and reporting fund balance in governmental funds.

8.129 AU-C section 501, *Audit Evidence—Specific Considerations for Selected Items* (AICPA, *Professional Standards*), provides guidance on planning and performing auditing procedures for financial statement assertions about derivative instruments, which include certain liabilities. AU-C section 501 is summarized in chapter 5 and the related AICPA Audit Guide *Special Considerations in Auditing Financial Instruments*.[27]

8.130 The auditor may use confirmations to verify certain information with other parties, such as IRC Section 457 plan balances, additions, and deductions with the plan administrator; grants, entitlements, and appropriations awarded and paid with recipients and subrecipients; deposits for systems development fees with land developers or individual property owners; landfill closure, postclosure care, and pollution remediation assets with the trustee; legal compliance of debt sales with bond counsel or appropriate oversight government; the existence of debt restrictions, terms, and proceeds with debt lenders or underwriters; debt principal balances outstanding at the financial reporting date and compliance with debt covenants with the trustee; and principal and interest payments during the year and cash held to pay matured or unmatured debt with the paying agent. See AU-C section 505, *External Confirmations* (AICPA, *Professional Standards*), for guidance about the confirmation process.

8.131 As discussed in paragraph 8.09, some grants, donations, and debt agreements impose finance-related requirements on the issuer. Although accounting and financial reporting standards and changes in those standards are not specifically designed to affect the evaluation of compliance with those requirements, some of those requirements may be written in such a manner that they could be affected. For example, a debt agreement may require a debt service reserve account that is based on a percentage of a particular revenue as reported in the government's GAAP financial statements. Because revenues may be measured differently in the government-wide and governmental fund financial statements, the government should determine the measure on which compliance should be evaluated. The government may need to consult the grantor, donor, or legal counsel in determining the effect of accounting and financial reporting standards on compliance requirements. The auditor might consider an evaluation of the government's determination as part of the financial statement audit.

8.132 As discussed in paragraph 8.118, there may be requirements for governments to disclose certain segment information. According to paragraph .A67 of AU-C section 501, the auditor's responsibility regarding the presentation and disclosure of segment information is in relation to the financial statements of the opinion unit(s) on which the segment information is based. Paragraph .25 of AU-C section 501 addresses the auditor requirements for segment information.

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[27] The AICPA Audit Guide *Special Considerations in Auditing Financial Instruments* also provides guidance on audit evidence that may be relevant to the fair value of derivative instruments and investments in securities.

Chapter 9

Interfund, Internal, and Intra-Entity Activity and Balances

Introduction

9.01 The need to properly account for and report interfund, internal, and intra-entity activity and balances is important in governmental financial reporting. The principal standards for classifying and reporting that activity and the resulting balances are in GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, as amended, paragraphs 57–62 and 112; GASB Statement No. 38, *Certain Financial Statement Note Disclosures*, as amended, paragraphs 14–15; and GASB Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues*, as amended, paragraph 15. Additional guidance is presented in paragraphs 6, 13, and 17 of the GASB *Implementation Guide No. 2015-1* (GASB IG 2015-1).

Nature of Transactions

> **Update 9-1** ***Fiduciary Activities***
>
> GASB Statement No. 84, *Fiduciary Activities*, establishes criteria for identifying and reporting fiduciary activities. The criteria for identification of fiduciary activities primarily focuses on (*a*) whether a government controls the assets of the fiduciary activity and (*b*) the beneficiaries with whom a fiduciary relationship exists.
>
> Governments with activities meeting the criteria will present a statement of fiduciary net position and a statement of changes in fiduciary net position, with certain exceptions.
>
> There are four classifications of fiduciary funds described in GASB Statement No. 84: (1) pension (and other employee benefit) trust funds, (2) investment trust funds, (3) private-purpose trust funds, and (4) custodial funds. Custodial funds should report fiduciary activities that are not held in a trust or equivalent arrangement that meets specific criteria. Note that agency funds will no longer be reported upon application of this statement.
>
> The statement was issued in January 2017 and is effective for fiscal years beginning after December 15, 2018. Earlier application is encouraged.
>
> The full text of the statement is available on GASB's website at www.gasb.org.

Nature of Interfund Activity and Balances

9.02 Interfund activity is a resource flow within and among the three fund categories—governmental, proprietary, and fiduciary—and includes resource flows between a primary government and its blended component units.[1] (Paragraph 9.05 discusses activity and balances between a primary government and its discretely presented component units.) Internal activities and balances do not meet the definition of financial statement elements outlined in GASB Concepts Statement No. 4, *Elements of Financial Statements*. However, activity and internal balances and transfers between reporting units of a governmental unit are reported along with assets, deferred outflows of resources, liabilities, deferred inflows of resources, net position, inflows of resources, and outflows of resources for purposes of fair presentation of each reporting unit. GASB Statement No. 34 paragraph 112, as amended, identifies two categories and four subcategories of interfund activity as follows:

a. *Reciprocal interfund activity* is the internal counterpart to exchange and exchange-like transactions. There are two types of reciprocal interfund activity:

   i. *Interfund loans* are amounts provided with a requirement for repayment.

   ii. *Interfund services provided and used* are purchases and sales of goods and services between funds for a price approximating their external exchange value. This includes most internal service fund activity.

b. *Nonreciprocal interfund activity* is the internal counterpart to nonexchange transactions. There are two types of nonreciprocal interfund activity:

   i. *Interfund transfers* are flows of assets between funds without equivalent flows of assets in return and without a requirement for repayment. This includes payments in lieu of taxes (PILOTs) that are not payments for, and are not reasonably equivalent in value to, services provided. (Some governments characterize PILOTs as interfund services provided and used; see paragraph 9.35.)

   ii. *Interfund reimbursements* are repayments from the funds responsible for particular expenditures or expenses to the funds that initially paid for them.

Interfund balances arise from unpaid interfund activity. See the detailed discussion of the accounting and financial reporting for interfund activity and balances at paragraphs 9.06–.15.

9.03 Internal service funds are one source of interfund activities and balances. GASB Statement No. 34 paragraph 68 states that internal service funds may be used to report any activity that provides goods or services to other funds, departments, or agencies of the primary government and its component units, or to other governments, on a cost-reimbursement basis. Internal service funds should be used only if the reporting government is the predominant participant in the activity.[2]

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[1] GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, as amended, provides that component units that are fiduciary in nature are displayed with fiduciary funds in the fiduciary fund financial statements. Those component units are treated the same as fiduciary funds and are therefore referred to in this guide as fiduciary funds.

[2] GASB *Implementation Guide No. 2015-1* (GASB IG 2015-1) question 7.50.9 indicates that, although usually clear, determining predominance requires preparer and auditor judgment.

Nature of Internal Activity and Balances

9.04 In the government-wide financial statements, internal activity and balances relate to interfund activity and balances reported in the fund financial statements. GASB Statement No. 34 paragraph 57, as amended, states "In the process of aggregating data for the statement of net position and the statement of activities, some amounts reported as interfund activity and balances in the funds should be eliminated or reclassified." See the detailed discussion of the accounting and financial reporting for internal activity and balances at paragraphs 9.16–.20.[3]

Nature of Intra-Entity Activity and Balances

9.05 Activity between primary governments and their discretely presented component units is known as intra-entity activity. Because of the separate nature of discretely presented component units, GASB Statement No. 34 paragraph 61, as amended, requires that activity between a primary government and its discretely presented component units be reported as if it relates to external transactions. See the detailed discussion of the accounting and financial reporting for intra-entity activity and balances at paragraph 9.21.

Accounting and Financial Reporting Considerations[4,5]

Reporting Interfund Activity and Balances

9.06 National Council on Governmental Accounting (NCGA) Statement 1, *Governmental Accounting and Financial Reporting Principles*, paragraphs 57, as amended, and 75 state that interfund transfers should be recognized in the period in which the interfund receivable and payable arise. The recognition and measurement standards for several types of interfund activity—such as risk financing activities, pension plan and other postemployment benefits plan other than pension plans contributions, nonexchange transactions, lease agreements, and the payment and receipt of the proceeds of tobacco settlement revenue bonds and other sales and pledges of receivables and future revenues between a primary government and its blended component units—are discussed in chapter 6, "Revenues and Receivables," chapter 8, "Expenses or Expenditures and Liabilities," and chapter 12, "Special-Purpose and State Governments," chapter 13, "Defined Benefit Pension Plans (Plan & Employer Considerations), and chapter 14, "Defined Benefit Postemployment Benefits Other Than Pensions (Plan & Employer Considerations)." Interfund movements of capital assets are discussed in chapter 7, "Capital Assets."

9.07 Table 9-1 summarizes the required reporting in the funds for the four types of interfund activity and balances, as discussed further in this section.

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[3] Chapter 2, "Financial Reporting," discusses how internal service fund assets and liabilities that are not eliminated in the government-wide statement of net position generally should be reported in the governmental activities column.

[4] Making disclosures for discretely presented component units is a matter of professional judgment, as discussed in chapter 3, "The Financial Reporting Entity."

[5] The discussion in paragraph 9.27 on differing year ends between a primary government and its component units affects the discussions on interfund, internal, and intra-entity activity and balances.

Table 9-1

Interfund Activity and Balances: Required Reporting

Type of Interfund Activity/Balances	*Financial Reporting*
Interfund loans	Generally, interfund receivables/payables (see paragraph 9.08)
Interfund services provided and used	Generally, revenues and expenditures/expenses (see paragraph 9.09)
Interfund transfers	Other financing sources/uses or after nonoperating revenues/expenses (see paragraph 9.10)
Interfund reimbursements	Expenditures/expenses only in the funds responsible for them (see paragraph 9.11)

9.08 Lender funds should report interfund loans as interfund receivables; however, borrower funds should report them as interfund payables. If repayment is not expected within a reasonable time, the interfund balances should be reduced, and the lender fund should report a transfer to the borrower fund for the amount that is not expected to be repaid within a reasonable time, regardless of the basis of accounting used in the fund financial statements. As discussed in question 7.82.1 of the GASB IG 2015-1, there is no precise definition of the "expected within a reasonable time" provision, and professional judgment will determine whether an interfund loan should be reclassified. However, that question also discusses the notions of *expectation* and *reasonable time*. For example, recurring payments made to reduce the interfund loan balance may provide evidence that "payment is expected." (See also paragraph 9.34.) Question 6.4.5 of the GASB IG 2015-1 indicates that a promissory note issued by one fund and purchased by another fund should be reported as an interfund loan in the fund financial statements.

9.09 Interfund services provided and used should be reported as revenues in seller funds and expenditures or expenses in purchaser funds. However, when the general fund is used to account for risk-financing activity, GASB Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, as amended, requires interfund charges to other funds to be accounted for as interfund transfers (which are discussed in paragraph 9.10) or as interfund reimbursements (which are discussed in paragraph 9.11), depending on the circumstances. (See the discussion of accounting for risk financing activities in chapter 8.)

9.10 In governmental funds, interfund transfers should be reported as other financing uses in the transferor funds and other financing sources in the recipient funds. In proprietary funds, transfers should be reported after nonoperating revenues and expenses.

9.11 Interfund reimbursements should reduce the expenditures or expenses in the funds that originally paid them and increase expenditures or expenses in the funds responsible for them. Consequently, reimbursements are not displayed as interfund activity in the financial statements, except on the statement of cash flows.

9.12 Unpaid amounts arising from interfund activity should be reported as interfund receivables and payables in the fund financial position statements, except as discussed in paragraph 9.08 for loans for which repayment is not expected within a reasonable time. NCGA Statement 1 footnote 5 states that where money is owed from one fund to another fund, and money is also owed from the latter to the former, the amounts receivable and payable should not be offset in the accounts. However, for purposes of reporting, that statement provides that current amounts due from and due to the same funds may be offset and the net amounts shown in the respective fund financial position statements.

9.13 GASB Statement No. 38 paragraph 14 requires the notes to the financial statements to disclose amounts due from other funds by individual major fund, nonmajor governmental funds in the aggregate, nonmajor enterprise funds in the aggregate, internal service funds in the aggregate, and fiduciary fund type. Governments also should disclose the purpose for interfund balances and interfund balances that are not expected to be repaid within one year from the date of the financial statements.

9.14 GASB Statement No. 38 paragraph 15 requires the following disclosures about interfund transfers reported in the fund financial statements:

- Amounts transferred from other funds by individual major fund, nonmajor governmental funds in the aggregate, nonmajor enterprise funds in the aggregate, internal service funds in the aggregate, and fiduciary fund type
- A general description of the principal purposes of the government's interfund transfers
- The intended purpose and the amount of significant transfers that meet either or both of the following criteria: (*a*) do not occur on a routine basis or (*b*) are inconsistent with the activities of the fund making the transfer

9.15 If a government chooses to use an internal service fund to account for its risk financing activities, GASB Statement No. 10, as amended, provides guidance. The statement generally provides that the total charge by the internal service fund to the other funds be based on an actuarial method or historical cost information and adjusted over a reasonable period of time so that internal service fund revenues and expenses are approximately equal. That guidance applies even though the fund may periodically report annual deficits or accumulated deficit net position. If the government cannot recoup such deficits over a reasonable period of time, however, the internal service fund deficit should be charged back to the user funds. For risk financing internal service funds, GASB Statement No. 10 paragraph 67, as amended, requires disclosure in the notes to the financial statements of (*a*) deficit net position and (*b*) designations of net position resulting from charging a reasonable provision for expected future catastrophe losses. (See chapter 8 for additional discussion of the accounting and financial reporting requirements for risk financing, including when using internal service funds.)

Reporting Internal Balances and Activity

9.16 In the government-wide statement of net position, some internal balances are reclassified or eliminated to minimize the "grossing up" effect on assets and liabilities within the governmental and business-type activities, including

a. amounts owed between the funds included in the governmental activities column are eliminated (that is, not reported in the statement of net position), as are amounts owed between funds included in the business-type activities column. This includes interfund receivables and payables relating to internal service fund activity.

b. amounts owed between governmental and business-type activities are presented as internal balances. However, those internal balances are ultimately eliminated in the "total primary government" column (paragraph 9.27 discusses these eliminations when a component unit's fiscal year differs from that of its primary government). As shown in the illustrative financial statements in the nonauthoritative appendix B7-1 of the GASB IG 2015-1, this is done either by (1) including both the receivable and payable on the same financial statement line as "internal balances" (reported with either assets or liabilities) that offset each other in the aggregation process or (2) adjusting the amounts out of the "total primary government" column, accompanied by a notice of the elimination.

c. amounts of receivables and payables between the primary government and fiduciary funds are reported as receivable from and payable to external parties, as required by GASB Statement No. 34 paragraph 58, as amended, rather than as internal balances.

9.17 Table 9-2 summarizes the required reporting in the government-wide financial statements for internal balances.

Table 9-2

Internal Balances Reporting in Government-Wide Financial Statements

Nature of Balance	***Reporting***
Between funds included in governmental activities column	Eliminate within the governmental activities column
Between funds included in business-type activities column	Eliminate within the business-type activities column
Between a fund included in governmental activities column and a fund included in the business-type activities column	Internal balance; eliminate in the total primary government column
Between the primary government and fiduciary funds	Report as receivable from/payable to external parties

9.18 Interfund transfers within governmental activities and within business-type activities should be eliminated and not presented in the statement of activities. Only the net amount transferred between governmental and business-type activities should be reported in the statement of activities, but that amount ultimately should be eliminated in the "total primary government" column. GASB IG 2015-1 question 7.47.16 indicates that the elimination can be achieved by combining all transfers in and transfers out within the separate governmental and business-type activities columns into a single line item on the statement of activities.

9.19 GASB Statement No. 34 paragraphs 59–60 provide the following additional guidance concerning eliminations of internal activity in the government-wide statement of activities:

a. Internal service fund activity is eliminated to remove the "doubling-up" effect. For example, suppose an internal service fund that is reported as governmental activities has revenues and expenses of $10,000 relating to sales to governmental funds. In determining the amount of revenues and expenses of government activities in the statement of activities, the aggregate fund revenues and expenses would be reduced by $10,000. Further, GASB IG 2015-1 question 7.47.6 indicates that eliminating the "effect" of internal service fund activity requires preparers to "look back" and adjust the internal service fund's internal charges to break even. That is, internal service fund net income from internal activity (the amount by which revenues exceeds expenses) would cause a pro rata reduction in the charges made to the participating functions or programs. Conversely, an internal service fund net loss would require a pro rata increase in the amounts charged to the participating functions or programs. The nonauthoritative exercise in appendix B7-3 of the GASB IG 2015-1 provides an example of eliminating the effect of internal service funds.

b. Internal events that are in effect allocations of overhead expenses between and within functions are eliminated so the allocated expenses are only reported by the function to which they were allocated. However, GASB IG 2015-1 question 7.47.13 indicates that, for practical reasons, elimination of internal activity within a single function (activity that has no effect on the net [expense] revenue of the function) is not necessary unless the effect on direct expenses or program revenues is material. That practical explanation does not change the standard for the elimination of internal activity within a single function, but rather recognizes the application of materiality considerations. A government that does not eliminate internal activity with a single function because it is following the "practical" approach should be able to demonstrate that the effect does not materially misstate the components of the net expense or net revenue of the function.

c. Amounts relating to interfund services provided and used between functions are not eliminated.

9.20 GASB Statement No. 34 paragraph 115c requires governments to disclose their policy for eliminating internal activity in the government-wide statement of activities. Question 7.84.2 of the GASB IG 2015-1 discusses the possible content of that required disclosure.

Reporting Intra-Entity Activity and Balances

9.21 As indicated in paragraph 9.05, GASB Statement No. 34 paragraph 61, as amended, requires that activity between a primary government and its discretely presented component units be reported as if it relates to external transactions. Consequently, loans and repayments between the primary government and its discretely presented component units should affect only the statement of net position. Intra-entity activity should be reported as revenues and expenses except for intra-entity transfers of future revenues, which are accounted for as deferred inflows of resources or deferred outflows of resources under paragraph 13 of GASB Statement No. 65, *Items Previously Reported as Assets and Liabilities*. Intra-entity receivables and payables should be reported on a separate line. See also the guidance in chapters 6 and 8, including the guidance on nonexchange transactions, and the guidance in chapter 12 on lease agreements and the payment and receipt of the proceeds of tobacco settlement revenue bonds and other such intra-entity payments and receipts of future revenues between primary governments and their component units.

9.22 GASB Statement No. 48 discusses exchanges by governments of interests in their expected cash flows from collecting specific receivables or specific future revenues for immediate cash payments. Paragraph 15 of GASB Statement No. 48, as amended, discusses how such exchanges occurring within a reporting entity should be accounted for.

9.23 If the purchasing government is a part of the same financial reporting entity as the selling government, then the sale is an intra-entity transaction. For example, a state government might sell receivables to one of its component units, such as a public authority. In this case, the public authority purchasing the state's receivables should recognize assets equal to the state's carrying value of the receivables. The difference between the purchase price and the carrying value would be accounted for as a revenue, expense, or expenditure by the public authority in its separately issued financial statements. However, in the financial statements of the state's reporting entity (of which both the state and the authority are a part), these amounts would be classified as transfers or subsidies between the two governmental entities.

9.24 In the case of a sale of future revenues between components of the same reporting entity, the buyer does not add an asset to its financial statements because no carrying value is reported by the seller. Assets and revenues would not be reported by the purchasing government until appropriate under generally accepted accounting principles (GAAP). The purchasing government would report the amount it paid as a deferred outflow of resources that would be spread over the life of the sale agreement. Each year a portion of the charge would be recognized as an expense or expenditure. The selling government likewise defers the revenue and recognizes revenue over the duration of the sales agreement. Paragraph 16 of GASB Statement No. 48, as amended, discusses amortization of the deferred outflow of resources.

9.25 A primary government may enter into a service concession arrangement with one or more of its discretely presented components. If specific criteria are met, the provisions of GASB Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements*, as amended, apply subject to the provisions of paragraph 15 in GASB Statement No. 48, as amended. Accounting and financial reporting for various types of service concession arrangements is discussed in chapter 7, chapter 8, and chapter 12.

9.26 GASB Statement No. 48, as amended, also discusses intra-entity transfers of assets, including capital assets. It states that when accounting for the transfer of capital assets within the same financial reporting entity, the transferee should recognize the assets received at the carrying value of the transferor (that is, they should not be revalued).[6] See chapters 6–7 for further discussion of GASB Statement No. 48, as amended.

Differing Year Ends

9.27 When a component unit's fiscal year differs from that of its primary government, internal activity and balances may not be fully eliminated in the government-wide financial statements, and interfund and intra-entity activity and balances may not equal. GASB Statement No. 14 paragraph 60, as amended, requires that if transactions between component units that have different fiscal years result in inconsistencies in amounts reported as due to or due from and so forth, the government should disclose the nature and amount of those transactions in the notes to the financial statements.

Auditing Considerations

9.28 The audit objectives for the interfund, internal, and intra-entity activity and balances of each opinion unit, categorized by financial statement assertion, are as follows:

- *Assertions about classes of transactions and events for the period under audit:*
  - — *Occurrence.* Reported interfund, internal, and intra-entity activity represent amounts relating to the period and pertain to the government.
  - — *Completeness.* The financial statements report all interfund, internal, and intra-entity activity relating to the period.
  - — *Accuracy.* Interfund, internal, and intra-entity activity are recorded at the proper amounts.
  - — *Cutoff.* Transactions and events have been recorded in the correct accounting period.
  - — *Classification.* Transactions and events have been recorded in the proper accounts.
- *Assertions about account balances at the period end:*
  - — *Existence.* Reported interfund, internal, and intra-entity balances represent amounts unpaid as of the end of the period.
  - — *Rights and obligations.* The financial statements properly reflect conditions and agreements that affect the entity's interfund, internal, and intra-entity balances as of the end of the period.

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[6] GASB IG 2015-1 question Z.48.4, as amended, describes a situation in which two parts of the same reporting entity have differing capitalization policies and reiterates that the transfers are to be made at the transferor's carrying value, regardless of whether the receiving function would have, or would not have, capitalized the asset under its own capitalization policy at some other value, or no value, had it purchased it or otherwise acquired it, such as through donation, from a party outside the reporting entity.

— *Completeness.* The financial statements report all interfund, internal, and intra-entity balances as of the end of the period.

— *Valuation and allocation.* Interfund, internal, and intra-entity balances are recorded at the proper amounts.

- *Assertions about presentation and disclosure:*

  — *Occurrence and rights and obligations.* Disclosed events and transactions relating to interfund, internal, and intra-entity activity and balances have occurred and pertain to the entity.

  — *Completeness.* All disclosures pertaining to interfund, internal, and intra-entity activity and balances that should have been included in the financial statements have been included.

  — *Classification and understandability.* Financial information pertaining to interfund, internal, and intra-entity activity and balances is appropriately presented and described and disclosures are clearly expressed.

  — *Accuracy and valuation.* The financial statements properly classify, describe, and disclose interfund, internal, and intra-entity activity and balances, including classification in the proper fund and activity. Financial statement presentation and disclosure are made in accordance with GAAP, consistently applied.

9.29 A government's interfund, internal, and intra-entity activity and balances often are subject to various compliance requirements. Although a government should be concerned with all compliance requirements, generally accepted auditing standards focus the auditor's concern on compliance requirements that have a direct and material effect on the determination of financial statement amounts. See the further discussion of the auditor's responsibility in this regard in chapter 4, "General Auditing Considerations."

9.30 The auditor should evaluate whether adequate procedures are performed related to each of those opinion units with material interfund, internal, and intra-entity activity and balances. (See the discussion of opinion units in chapter 4.) When obtaining an understanding of controls that are relevant to the audit, the auditor should evaluate the design of the controls and evaluate whether they have been implemented by performing procedures in addition to the inquiry of government personnel, including obtaining an understanding of the government's internal control over interfund, internal, and intra-entity activity and balances. Internal control features related to that activity may include the following:

- Legislative or budgetary authorization for the activities
- A process to ensure that the activities are properly authorized and in accordance with budgetary authorization before they are initiated, including periodic supervisory review
- Policies and procedures to ensure that the activities are properly recorded and classified in the accounting records, including that they are properly identified as interfund or intra-entity activities

- Processes to ensure that internal service fund charges are appropriate and are in accordance with GAAP
- Policies and procedures to periodically review outstanding interfund loans for reclassification as interfund transfers
- Policies and procedures to ensure that the activities are presented and disclosed in the financial statements in accordance with GAAP, including processes to make appropriate eliminations and reclassifications for internal activity and balances in the government-wide financial statements

9.31 Audit procedures relating to interfund, internal, and intra-entity activity and balances may include the following:

- Reviewing minutes of the governing body, adopted budget, appropriate debt issuance documents, and other legal and contractual provisions for authorization of the activities and for any restrictions that could have a direct and material effect on the determination of financial statement amounts.
- Examining a sample of activities to ensure they are appropriately authorized, within budget, properly recorded in the accounting records, and appropriately reported and classified in the financial statements.
- Reviewing interfund and intra-entity balances for age, anticipated liquidation method, and collectibility.
- Evaluating whether internal service fund charges are appropriate and are in accordance with GAAP.
- Reviewing and analyzing the entity's eliminations and reclassifications of internal activity and balances in the government-wide financial statements, including those for internal service fund and similar cost allocation activities.
- Evaluating whether (*a*) interfund receivables equal interfund payables and whether transfers in equal transfer out, (*b*) internal activity and balances are fully eliminated in the government-wide financial statements, and (*c*) amounts of intra-entity activity and balances are consistent between the primary government and its discretely presented component units and between those component units. (These conditions may be affected by differing fiscal year ends between the primary government and its component units and between component units.)
- Evaluating whether the entity's note disclosures relating to the activities and balances are complete and presented in accordance with GAAP.

9.32 A government's accounting systems, processes, and records may not provide sufficient information about interfund activities to enable the government to report interfund activity and balances in the fund financial statements or to eliminate internal activity and balances in the government-wide financial statements in accordance with GAAP. Paragraph .05 of AU-C section 450, *Evaluation of Misstatements Identified During the Audit* (AICPA, *Professional Standards*), states that the auditor should accumulate misstatements identified during the audit, other than those that are clearly trivial. The auditor should communicate on a timely basis with the appropriate level of management all misstatements accumulated during the audit, and request management to correct those misstatements. If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor should obtain an understanding of the reasons management did not make the corrections. The auditor should take this into account when evaluating whether the financial statements are free of material misstatement. In making this evaluation, the auditor should consider whether the GAAP departure is material to one or more opinion units.

9.33 An internal service fund is operated on a cost-reimbursement basis. Cost is most often interpreted as all expenses, including capital costs. For an internal service fund to operate on a cost-reimbursement basis, its charges to other funds should result in revenues and expenses that are approximately equal over time, even though it periodically may report annual increases or decreases in net position. Because the intent of internal service funds is to facilitate cost allocation, the accumulation of net position surpluses or deficits over time generally[7] indicates that service is no longer being made on a cost-reimbursement basis, and the auditor should consider evaluating whether the activity continues to qualify for reporting in an internal service fund. Further, grantors often require that grantees allocate internal service fund costs to grant programs using the same methodology they use to allocate costs internally. Surpluses in internal service funds could lead a grantor to seek a recovery. The auditor should consider evaluating the effect that compliance requirements have on internal service fund charges made to grant programs and on surpluses in those funds. (Chapter 4 discusses the auditor's responsibility for financial statement misstatements arising from noncompliance with laws and regulations.)

9.34 As discussed in paragraph 9.08, interfund loans include only amounts that are expected to be repaid within a reasonable time. GASB has left the judgment of what constitutes "the expectation of a reasonable time" to financial statement preparers and auditors. When a government reports interfund loans, the auditor should consider evaluating whether the borrowing fund has both the ability and intent to repay within a reasonable time. In evaluating a fund's ability to repay the interfund loan within a reasonable time, the auditor may consider factors such as the fund's current financial position and estimates of future resources. In evaluating the intent to repay, the auditor may consider factors such as the purpose of the loan, the established repayment terms, the loan's current status, and management's representations.

9.35 Some governments characterize payments between funds as services provided and used when the payments are reasonably equivalent in value to the services provided. Those payments may be referred to by different terms, but when they involve enterprise funds, the payments sometimes are referred to as PILOT. The government should have documentation supporting its conclusion that the payment is reasonably equivalent in value to the services provided for the payment to be characterized as services provided and used. The auditor should consider evaluating whether the documentation supports the government's conclusion. A government's failure to provide support for its conclusion

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[7] GASB Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, paragraph 67, as amended, does not require that deficits, if any, in a risk financing internal service fund that result from certain pricing methods be charged back to the other funds in any one year, as long as adjustments are made over a reasonable period of time. See the further discussion in paragraph 9.15 and chapter 8, "Expenses or Expenditures and Liabilities."

limits the auditor's ability to evaluate whether the appropriate accounting has been applied in the preparation of the basic financial statements. That is a scope limitation that the auditor should evaluate in developing his or her opinions on the basic financial statements.

Chapter 10

Net Position and Financial Statement Reconciliations

Nature of Transactions

10.01 Generally accepted accounting principles (GAAP) have unique provisions for the display of net position and fund balances in governmental financial statements. The principal GASB pronouncements that address the display of net position and fund balance are National Council on Governmental Accounting (NCGA) Statement 1, *Governmental Accounting and Financial Reporting Principles as amended*; GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, as amended; GASB Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*, as amended; and GASB Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*. Depending on the financial statements involved, net position/fund balance is displayed based on restrictions on the use of the related resources or on the extent to which a government is bound to observe constraints imposed upon the use of the resources reported in governmental funds.

10.02 GASB Concepts Statement No. 4, *Elements of Financial Statements*, defines *net position* as the residual of all other elements presented in a statement of financial position. The term *net position* is used to refer to the residual of all other elements presented in a statement of financial position, whereas governmental funds use the term *fund balance* for this residual in the governmental funds balance sheet.

10.03 GASB Concepts Statement No. 4 does not specifically deal with the display of net position in governmental financial statements. Rather, the statement identifies the seven elements that are the fundamental components of government financial statements. Net position is the residual of all other elements presented in a statement of financial position. According to GASB Statement No. 63, net position reported in governmental financial statements is measured by the difference between (*a*) assets and deferred outflows of resources and (*b*) liabilities and deferred inflows of resources. Such differences are reported as (*a*) changes in net position reported in the associated activity statement; and (*b*) prior-period adjustments, including changes in accounting principles that are applied retroactively, changes in the financial reporting entity, and corrections of an error. Otherwise, no amounts are reported in the financial statements as direct changes to net position. Further, total net position does not change as a result of changes in the composition of the components of net position.

10.04 The totals and subtotals of net position and changes in net position reported in the various financial statements might differ from the amounts reported in the other financial statements because of the scope of activities reported and the measurement focus and basis of accounting (MFBA) used. Therefore, GASB Statement No. 34 as amended requires certain summary reconciliations between the amounts reported in the various financial statements.

Financial Reporting Considerations

10.05 This section discusses various standards relating to the presentation of net position and its components in the various financial statements and the related note disclosures. It also discusses the required financial statement reconciliations. Additional guidance is provided in paragraph 13, "Basic Financial Statements and Management's Discussion and Analysis," of the GASB *Implementation Guide No. 2015-1* (GASB IG 2015-1).

Government-Wide Net Position

10.06 Paragraphs 32–37 of GASB Statement No. 34, as amended by paragraphs 7–11 of GASB Statement No. 63, require the difference between a government's assets and deferred outflows of resources and its liabilities and deferred inflows of resources reported in the government-wide statement of net position to be labeled *net position* and to be displayed in three components: *net investment in capital assets*, *restricted*, and *unrestricted*. The following explains each component:

- *Net investment in capital assets* consists of capital assets, including restricted capital assets, reduced by accumulated depreciation and by any outstanding debt incurred to acquire, construct, or improve those assets (including any unamortized original issue discounts or premiums related to the debt).[1] Deferred outflows of resources and deferred inflows of resources that are attributable to the acquisition, construction, or improvement of those assets or related debt (such as deferred losses on advance refundings) are also included in this component of net position. If there are significant unspent proceeds of capital-related debt or deferred inflows of resources at year-end, this component does not include the portion of the debt or deferred inflows of resources attributable to the unspent amount. Instead, that debt or deferred inflow of resources is included in the same net position component (restricted or unrestricted) as the unspent proceeds, for example, "restricted for capital projects."[2]
- *Restricted net position* consists of restricted assets and deferred outflows of resources reduced by liabilities and deferred inflows of resources related to those assets and deferred outflows of resources. Generally, a liability relates to restricted assets if the

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[1] According to GASB *Implementation Guide No. 2015-1* (GASB IG 2015-1) question 7.22.9, accrued interest on any capital-related debt, including deep-discount debt, generally should not be included in the computation of the *net investment in capital assets* component of net position. The amount of the "borrowing attributable to the acquisition, construction, or improvement" of a capital asset is the proceeds, rather than the total amount, including interest, that will be paid at maturity. Generally, the accrued interest liability would be included in unrestricted net position. However, if the government has established a "sinking" fund to accumulate cash to pay off the debt at maturity, the accrued interest would be included in (reduce) the same component of net position as the sinking fund resources.

[2] GASB IG 2015-1 question 7.23.10 indicates that bonds related to capital assets of another entity are not capital-related debt of the issuing government even though the assets acquired may benefit its residents. GASB IG 2015-1 question 7.22.15 indicates that closure and postclosure care liabilities for municipal solid waste landfills are not capital-related debt. GASB IG 2015-1 question 7.23.12 indicates that a discretely presented component unit (see chapter 3, "The Financial Reporting Entity") that borrows money and lends it to its primary government to use for capital infrastructure projects should not consider that borrowing as capital-related debt.

assets result from a resource flow that also results in the recognition of a liability or if the liability will be liquidated with restricted assets reported. Restricted assets are those assets with restrictions on their use that are externally imposed (by creditors, grantors, contributors, or the laws or regulations of other governments) or that are imposed by the government's own constitutional provisions or enabling legislation. GASB Statement No. 46, *Net Assets Restricted by Enabling Legislation—an amendment of GASB Statement No. 34*, as amended, clarifies that, for this purpose, a legally enforceable enabling legislation restriction is one that a party external to a government can compel a government to honor. Footnote 25 of GASB Statement No. 34 states that enabling legislation also includes restrictions established by a governmental utility's own governing board when that utility's financial statements are based on paragraphs 476–500 of GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, as amended. GASB Statement No. 46, as amended, also specifies the accounting and financial reporting requirements if new enabling legislation replaces existing enabling legislation or if legal enforceability is reevaluated. GASB IG 2015-1 questions 7.24.15–7.24.24 address a variety of enabling legislation restriction evaluation and disclosure issues.

GASB IG 2015-1 question 7.24.13 explains that negative amounts should not be reported for any category of restricted net position. If liabilities that relate to specific restricted assets exceed those assets, no restricted net position balance should be reported; the net negative amount should reduce unrestricted net position.

Separate line items should distinguish among major categories of restrictions. When permanent endowments, permanent fund principal amounts, or minority interest in a component unit are included, restricted net position is displayed in two subcomponents: expendable and nonexpendable.[3] GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, paragraph 22, as amended, requires that net position that results from endowments and similar transactions be reported as restricted for as long as the provider's purpose restrictions or time requirements remain in effect.[4]

In addition, GASB IG 2015-1 question 7.24.26 explains that if a government provides a *match* to receive a donation that will be classified into restricted net position, the match portion similarly is considered to be part of restricted net position.

- GASB IG 2015-1 question 7.24.6 clarifies that this display requirement does not apply to term endowments. The objective of the display requirement is to identify net position that cannot be spent. Term endowments currently may be nonexpendable, but at some

[3] Nonexpendable restricted net position is the principal of a permanent endowment or permanent fund that is required to be retained in perpetuity.

[4] GASB IG 2015-1 question 7.24.27 indicates that earnings on a donor-restricted endowment that the entity (university) voluntarily reinvests into the endowment with the same restrictions as previous principal amounts also should be classified as (nonexpendable) restricted net position.

point in the future (when the term expires) they will become expendable. GASB IG 2015-1 question 7.24.29 discusses the valuation of nonexpendable net position in a situation in which the fair value of a permanent endowment is less than its original principal amount.

- *Unrestricted net position* is the net amount of the assets, deferred outflows of resources, liabilities, and deferred inflows of resources that are not included in the determination of net investment in capital assets or the restricted component of net position.

Designations of net position, which represent management intentions for the use of resources, should not be reported in the statement of net position. However, GASB Statement No. 34, as amended, does not prohibit governments from disclosing those designations in the notes to financial statements.

10.07 The illustrative financial statements in the nonauthoritative appendix B7-1 of the GASB IG 2015-1 present the display of the net position section of the government-wide statement of net position as shown in table 10-1.

Table 10-1

Net Position—Government-Wide Financial Statements

	Primary Government			
	Governmental Activities	*Business Activities*	*Total*	*Component Units*
Net investment in capital assets	XXX,XXX	XXX,XXX	XXX,XXX	XX,XXX
Restricted—nonexpendable	XXX,XXX	—	XXX,XXX	—
Restricted for:				
Transportation and public works	XX,XXX	—	XX,XXX	XXX
Debt service	X,XXX	X,XXX	X,XXX	—
Housing and community redevelopment	X,XXX	—	X,XXX	—
Other purposes	X,XXX	—	X,XXX	—
Unrestricted (deficit)	(X,XXX)	XX,XXX	X,XXX	X,XXX
Total net position	$XXX,XXX	$XXX,XXX	$XXX,XXX	$XX,XXX

10.08 The amount of net position reported for a primary government in the government-wide financial statements usually will differ from the aggregate amount of net position or fund balance reported in its fund financial statements. One reason for this difference is that the government-wide financial statements use a different MFBA than do the governmental fund financial statements. Another reason for this difference is that the government-wide financial statements do not include the amounts reported in the fiduciary fund financial statements. (See paragraphs 10.19–.21.)

Proprietary Fund Net Position

10.09 Paragraph 8 of GASB Statement No. 63 requires the residual amount of all other elements be reported as net position rather than net assets, proprietary fund balance, or equity. GASB Statement No. 34 paragraph 98, as amended, requires the display of net position using the three components discussed in paragraph 10.06. (See also table 10-1.) Net position resulting from capital contributions and designations of net position should not be displayed as such in the proprietary fund statement of net position.

Governmental Fund Balances

10.10 GASB Statement No. 54, as amended, requires fund balance reported in the governmental fund balance sheet to be classified using a hierarchy based primarily on the extent to which a government is bound to honor constraints on the specific purposes for which amounts in those funds can be spent. Governmental fund balance is to be classified as

- nonspendable.
- restricted.
- committed.
- assigned.
- unassigned.

10.11 *Nonspendable fund balance* includes amounts that cannot be spent because they are not in spendable form or are legally or contractually required to be maintained intact. The "not in spendable form" criterion includes items that are not expected to be converted to cash (for example, inventories and prepaid amounts), long-term loans and notes receivable, as well as property acquired for resale.[5] If the use of the proceeds from the collection of those receivables or from the sale of those properties is restricted, committed, or assigned, then they should be included in the appropriate fund balance classification (restricted, committed, or assigned), rather than nonspendable fund balance. The corpus (or principal) of a permanent fund is an example of an amount that is legally or contractually required to be maintained intact. For fund balance reporting purposes, amounts required to be retained in perpetuity should be classified as nonspendable and as nonexpendable within the restricted net position category in the government-wide statements.

10.12 *Restricted fund balance* is the amount that is restricted to specific purposes, pursuant to the definition of restricted in paragraph 34 of GASB Statement No. 34, as amended. Except as discussed in paragraph 10.11 for amounts that are "required to be retained in perpetuity," fund balance should be reported as restricted when the use of resources is constrained either by (*a*) external impositions by creditors, grantors, contributors, or laws or regulations of other governments or (*b*) impositions by law through constitutional provisions or enabling legislation.[6]

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[5] Encumbrances do not represent nonspendable resources. Amounts encumbered for specific purposes for which resources already have been restricted, committed, or assigned should not result in separate display of the encumbered amounts within those classifications. Encumbered amounts for specific purposes for which amounts have not been previously restricted, committed, or assigned should not be classified as unassigned but, rather, should be included within committed or assigned fund balance, as appropriate.

[6] *Enabling legislation*, as the term is used in GASB Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*, as amended, authorizes the government to assess, levy, charge, or otherwise mandate payment of resources (from external resource providers) and includes a legally enforceable requirement that those resources be used only for the specific purposes stipulated in the legislation. Legal enforceability means that a government can be compelled by an external party—such as citizens, public interest groups, or the judiciary—to use resources created by enabling legislation only for the purposes specified by the legislation.

10.13 *Committed fund balance* is the amount that can only be used for specific purposes pursuant to constraints imposed by the most binding[7] formal action of the government's highest level of decision-making authority. Such amounts cannot be used for any other purpose unless the government removes or changes the specified use by taking the same type of action (for example, legislation, resolution, ordinance) it employed to previously commit those amounts. The formal action of the government's highest level of decision-making authority that commits fund balance to a specific purpose should occur prior to the end of the reporting period, but the amount, if any, which will be subject to the constraint, may be determined in the subsequent period. Committed fund balance also should incorporate contractual obligations to the extent that existing resources in the fund have been specifically committed for use in satisfying those contractual requirements.

10.14 *Assigned fund balance* is the amount that is constrained by the government's intent to be used for specific purposes, but is not restricted or committed. Intent should be expressed by (*a*) the governing body itself or (*b*) a body (a budget or finance committee, for example) or official to which the governing body has delegated the authority to assign amounts to be used for specific purposes. The nature of the action necessary to remove or modify an assignment is not as prescriptive as it is for committed fund balance classifications. Constraints imposed on the use of assigned amounts are more easily removed or modified than those imposed on amounts that are classified as committed. Assigned fund balance includes (*a*) all remaining amounts (except for negative balances) reported in governmental funds, other than the general fund, that are not classified as nonspendable and are neither restricted nor committed and (*b*) amounts in the general fund that are intended to be used for a specific purpose. Fund balances in a special revenue, capital projects, debt service, or permanent fund that are not restricted or committed are reported as assigned fund balance in the respective funds. Assigned fund balance in the general fund represents the intended use of that amount for a specific purpose. Governments should not report assigned fund balance if such assignment results in a deficit in unassigned fund balance.

10.15 *Unassigned fund balance* is the residual classification for the general fund. This classification represents fund balance that has not been assigned to other funds, that is not nonspendable, and that has not been restricted, committed, or assigned to specific purposes within the general fund. The general fund should be the only fund that reports a positive unassigned fund balance amount. In other governmental funds, if expenditures incurred for specific purposes exceeded the amounts restricted, committed, or assigned to those purposes, it may be necessary to report a negative unassigned fund balance in those funds.

10.16 A government's accounting policy regarding which resources (that is, restricted, committed, assigned, or unassigned) are considered to be spent first for expenditures for which more than one resource classification is available, determines the fund balance classifications for financial reporting purposes. For example, an expenditure may be incurred for purposes for which

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[7] GASB IG 2015-1 question Z.54.51 provides that only the action that constitutes the most binding constraint should be considered a commitment for fund balance classification purposes. However, if two actions that follow a different process to be passed, such as an ordinance and a resolution, but essentially result in a commitment that is equally binding, then both meet the criteria to establish a fund balance commitment.

restricted, committed, assigned, and unassigned resources are available. If a government does not establish a policy for its use of fund balance amounts, expenditures should be applied against restricted resources first, then committed, assigned, and unassigned, respectively, as applicable.[8]

10.17 Some governments formally set aside amounts in governmental funds under formal stabilization-type policies[9] that can be expended only when certain specific nonroutine circumstances exist. For purposes of reporting fund balance, stabilization amounts should be reported in the general fund as restricted or committed if they meet the criteria set forth in GASB Statement No. 54, as amended, based on the source of the constraint on their use. Stabilization arrangements that do not meet the criteria to be reported within the restricted or committed fund balance classifications should be reported as unassigned in the general fund.

10.18 The two components of nonspendable fund balance (not in spendable form and legally or contractually required to be maintained intact) and specific purposes details for restricted, committed, and assigned fund balance may be displayed on the face of the balance sheet or each classification may be presented in the aggregate. If presented in the aggregate, the components of nonspendable fund balance and specific purposes details for restricted, committed, and assigned fund balance should be disclosed in the notes to the financial statements. GASB IG 2015-1 question Z.54.61 clarifies that the notes to the financial statements should provide this information for the general fund, each major governmental fund, and the nonmajor funds in the aggregate. The appendix to GASB Statement No. 54, as amended, presents nonauthoritative illustrations of the display of the fund balance section of the governmental fund balance sheet. The two nonauthoritative illustrative options (that is, both in detail and in the aggregate) shown in table 10-2 and table 10-3 are adapted from the appendix to GASB Statement No. 54, as amended.

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[8] If a government does not establish a policy for its use of *unrestricted* fund balance amounts, under the provisions of GASB Statement No. 54, as amended, it should consider that committed amounts would be reduced first, followed by assigned amounts, and then unassigned amounts when expenditures are incurred for purposes for which amounts in any of those unrestricted fund balance classifications could be used.

[9] Typical purposes for which stabilization funds are set aside include emergency situations; unanticipated significant revenue shortages or budgetary imbalances; working capital needs; contingencies; and others. The authority for such funds generally is derived from statute, ordinance, resolution, charter, or constitution.

Table 10-2

Fund Balance Section of Governmental Funds Balance Sheet (in detail)

	General Fund	*Major Highway Fund*	*Major School Aid Fund*	*Major Debt Service Fund*	*Other Funds*	*Total*
Fund balances:						
Nonspendable:						
Inventory	XXX	XXX	XX	—	—	XXX
Permanent fund principal	—	—	—	—	XXX	XXX
Restricted for:						
Social services	XXX	—	—	—	—	XXX
Parks and recreation	XX	—	—	—	XX	XXX
Debt service reserve	—	—	—	XX	—	XX
Other purposes	XX	—	—	—	—	XX
Committed for:						
Zoning board	XX	—	—	—	—	XX
Education	XXX	—	XXX	—	—	XXX
Assigned to:						
Library acquisitions	XX	—	—	—	XX	XXX
Highway resurfacing	—	XXX	—	—	—	XXX
Debt service	—	—	—	XX	—	XX
Unassigned	XXX	—	—	—	—	XXX
Total fund balances	X,XXX	X,XXX	XXX	XXX	X,XXX	XX,XXX

Table 10-3

Fund Balance Section of Governmental Funds Balance Sheet (in the aggregate)

	General Fund	*Major Highway Fund*	*Major School Aid Fund*	*Major Debt Service Fund*	*Other Funds*	*Total*
Fund balances:						
Nonspendable	XXX	XXX	XX	—	—	XXX
Restricted	—	—	—	—	XXX	XXX
Committed	XXX	—	—	—	—	XXX
Assigned	XX	—	—	—	XX	XXX
Unassigned	XX	—	—	—	—	XX
Total fund balances	X,XXX	X,XXX	XX,XXX	X,XXX	X,XXX	XX,XXX

Reconciliations—Net Position and Changes in Net Position

10.19 As discussed in paragraph 10.08, the amount of net position reported for a primary government in the government-wide statement of net position usually will differ from the aggregate amount of net position or fund balance reported in its fund financial position statements. Similarly, there will be differences between the changes in net position or fund balance reported in the various activity statements. To explain those differences, GASB Statement No. 34 paragraph 77 requires summary reconciliations to the government-wide financial statements to be presented at the bottom of the fund financial statements or in an accompanying schedule. GASB IG 2015-1 question 7.57.2 explains that when space permits, the reconciliation can be presented on the same page as, but to the right of, the fund financial statements, rather than at the bottom of the page. It also explains that if an accompanying schedule is used, it should be considered a continuation of the fund financial statement and therefore be presented immediately following the statement it supports. Generally, brief explanations on the face of the financial statements suffice. However, governments should provide more detail in the notes to the financial statements if aggregated information in the summary reconciliation on the financial statements obscures the nature of individual elements of a particular reconciling item.

10.20 For governmental funds, GASB Statement No. 34, as amended, requires total governmental fund balances to be reconciled to the net position of governmental activities. It also requires the total changes in the governmental fund balances to be reconciled to the change in net position of governmental activities. Typical differences that require reconciliation include net position and changes in net position arising from capital assets, revenues that are reported as deferred inflows of resources because they are not available, and long-term liabilities (including debt issuances and repayments) as well as the residual assets and liabilities of internal service funds (which, as discussed in chapter 2, "Financial Reporting," generally are reported with governmental activities in the government-wide financial statements).

10.21 For enterprise funds, (*a*) total enterprise fund net position should be reconciled to the net position of business-type activities and (*b*) the total change in enterprise fund net position should be reconciled to the change in net position of business-type activities provided there are differences that require reconciliation. GASB Statement No. 34 paragraph 104, as amended, states that generally there are no reconciling items between the enterprise funds and business-type activities. That is, the amounts reported as total enterprise fund net position and changes in net position usually are the same as net position and changes in net position of business-type activities. However, there may be differences that require reconciliation. For example, in the process of eliminating internal service fund activities for the statement of activities, some of the fund's net income or loss may be allocated to business-type activities. Also, the residual assets and liabilities of internal service funds are reported with business-type activities in certain situations. Further, GASB IG 2015-1 questions 7.28.4 and 7.75.1 indicate that differences may arise from (*a*) allocating indirect costs from governmental activities to business-type activities and (*b*) reporting enterprise funds with governmental activities or governmental funds with business-type activities.

Fiduciary Fund Net Position

Update 10-1 *Fiduciary Activities*

GASB Statement No. 84, *Fiduciary Activities*, establishes criteria for identifying and reporting fiduciary activities. The criteria for identification of fiduciary activities primarily focuses on (a) whether a government controls the assets of the fiduciary activity and (b) the beneficiaries with whom a fiduciary relationship exists.

Governments with activities meeting the criteria will present a statement of fiduciary net position and a statement of changes in fiduciary net position, with certain exceptions.

There are four classifications of fiduciary funds described in GASB Statement No. 84: (1) pension (and other employee benefit) trust funds, (2) investment trust funds, (3) private-purpose trust funds, and (4) custodial funds. Custodial funds should report fiduciary activities that are not held in a trust or equivalent arrangement that meets specific criteria. Note that agency funds will no longer be reported upon application of this statement.

The statement was issued in January 2017 and is effective for fiscal years beginning after December 15, 2018. Earlier application is encouraged.

Upon its effective date, GASB Statement No. 84 will affect the guidance in this chapter.

The full text of the statement is available on GASB's website at www.gasb.org.

10.22 GASB Statement No. 34 paragraph 108, as amended, requires the residual amount of all other elements reported in the fiduciary fund statement of fiduciary net position to be labeled *net position* but does not require net position to be displayed in the components of net position as discussed in paragraph 10.06. Specific display requirements for pension and other employee benefit trust funds and investment trust funds in GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, as amended; No. 67, *Financial Reporting for Pension Plans—an amendment of GASB Statement No. 25*; and No. 74, *Financial Reporting for Postemployment Benefit Plans Other than Pension Plans*, require net position to be labeled to indicate the purpose for which they are held. Examples of the specific display requirements of these statements include "net position restricted for pensions" (GASB Statement No. 67) and "net position restricted for postemployment benefits other than pensions" (GASB Statement No. 74). The illustrative financial statements in the nonauthoritative appendix B7-1 of the GASB IG 2015-1 present the single net position line item for both a pension trust fund and a private-purpose trust fund as net position "restricted for pension and other purposes."

Disclosures

10.23 Governments should disclose the following related to their fund balance in their governmental funds:

- Committed fund balance. The government's highest level of decision-making authority and the formal action required to be taken to establish (and modify or rescind) a fund balance commitment.

- Assigned fund balance. The body or official authorized to assign amounts to a specific purpose (if appropriate) and the policy established by the governing body pursuant to which that authorization is given.
- Whether the government considers restricted or unrestricted amounts to have been spent when an expenditure is incurred for purposes for which both restricted and unrestricted fund balance is available and whether committed, assigned, or unassigned amounts are considered to have been spent when an expenditure is incurred for purposes for which amounts in any of those unrestricted fund balance classifications could be used.
- Encumbrances, if significant, should be disclosed by major funds and nonmajor funds in the aggregate in conjunction with required disclosures about other significant commitments.
- Details of fund balance classifications displayed in the aggregate on the face of the balance sheet including amounts for the two nonspendable components (that is, not in spendable form and legally or contractually required to be maintained intact) and specific purposes information (for restricted, committed, and assigned fund balances).
- Information related to stabilization arrangements (even if an arrangement does not meet the criteria to be classified as restricted or committed) including the
  - — authority for establishing stabilization arrangements (for example, by statute or ordinance).
  - — requirements for additions to the stabilization amount.
  - — conditions under which stabilization amounts may be spent.
  - — stabilization balance, if not apparent on the face of the financial statements.
- Description of the minimum fund balance policy (if formally adopted by the governing body) and the minimum amount under the policy.
- Purpose for each major special revenue fund and the revenues and other resources reported in each of those funds.
- Deficit fund balances of nonmajor governmental funds.
- Details of the different types of deferred outflows of resources and deferred inflows of resources reported in a governmental fund balance sheet if significant components of the total deferred amounts are obscured by aggregation.

10.24 Governments should disclose the following related to their government-wide and enterprise fund net position if the information is not apparent on the face of the financial statements:[10]

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[10] Making disclosures for discretely presented component units is a matter of professional judgment, as discussed in chapter 3.

- The amount of the primary government's net position at the end of the reporting period that is restricted by enabling legislation (GASB Statement No. 46 paragraph 6, as amended)[11]
- The government's policy regarding whether to first apply restricted or unrestricted resources when an expense is incurred for purposes for which both restricted and unrestricted components of net position are available (GASB Statement No. 34 paragraph 115, as amended)
- A deficit net position of nonmajor enterprise funds (NCGA Interpretation 6, *Notes to the Financial Statements*, paragraph 4, as amended)
- Detailed explanations of reconciliations between the fund and government-wide financial statements, if appropriate (See paragraph 10.19)
- Details of the different types of deferred outflows of resources and deferred inflows of resources reported in a statement of net position if significant components of the total deferred amounts are obscured by aggregation (GASB Statement No. 63 paragraph 12).
- An explanation of the difference between a deferred outflow of resources or deferred inflow of resources and the related asset or liability resulting from a transaction that recognizes a deferred outflow of resources or deferred inflow of resources, if significant (GASB Statement No. 63, paragraph 13).

Auditing Considerations

10.25 The audit objectives for the net position of each opinion unit, categorized by financial statement assertion, are as follows:

- *Assertions about classes of transactions and events for the period under audit*:
  - — *Occurrence.* Reported changes in net position are based on actual transactions or other events relating to the period and pertain to the government.
  - — *Completeness.* The financial statements report all changes in net position relating to the period.
  - — *Accuracy.* Amounts and other data relating to recorded net position transactions and events have been recorded appropriately.
  - — *Cutoff.* Net position transactions and events have been recorded in the correct accounting period.
  - — *Classification.* Net position transactions and events have been recorded in the proper accounts.
- *Assertions about account balances at the period end*:

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[11] GASB IG 2015-1 question 7.24.16 states that a government may choose to disclose net position restricted by enabling legislation (*a*) by major categories of restrictions, (*b*) separately for governmental and business-type activities, or (*c*) as a single amount for the primary government.

- *Existence.* Reported net position and its components are based on actual transactions or other events as of the end of the period.
- *Rights and obligations.* The financial statements properly reflect conditions and agreements that affect the entity's net position and its components as of the end of the period.
- *Completeness.* The financial statements report all net position as of the end of the period.
- *Valuation and allocation.* Net position and its components are reported at the proper amounts.

- *Assertions about presentation and disclosure*:
  - *Occurrence and rights and obligations.* Disclosed net position events and transactions have occurred and pertain to the government.
  - *Completeness.* All net position disclosures that should have been included in the financial statements have been included.
  - *Classification and understandability.* Net position financial information is appropriately presented and described and disclosures are clearly expressed.
  - *Accuracy and valuation.* The financial statements properly classify, describe, and disclose net position and its components, including classification in the proper fund and activity. Financial statement presentation and disclosures are made in accordance with GAAP, consistently applied.

10.26 Items that are presented in the financial statement reconciliations result from recognition and scope differences between the financial statements. Consequently, audit objectives for the transactions underlying those differences (for example, evaluating whether all expenses or expenditures and liabilities are identified, recorded, and disclosed in the government-wide financial statements and the fund financial statements) also represent audit objectives for the components of the reconciliations. However, an additional audit objective concerns presentation and disclosure—whether the reconciliations are presented and disclosed in accordance with GAAP.[12]

10.27 A government's net position accounts often are subject to various compliance requirements. Although a government should be concerned with all compliance requirements, generally accepted auditing standards focus the auditor's concern on compliance requirements that have a direct and material effect on the determination of financial statement amounts. See further discussion of the auditor's responsibility in this regard in chapter 4, "General Auditing Considerations."

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[12] Paragraph .21 of AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), states the auditor's substantive procedures should include audit procedures related to the financial statement closing process, such as agreeing or reconciling the financial statements with the underlying accounting records and examining material journal entries and other adjustments made during the course of preparing the financial statements.

10.28 The auditor should obtain sufficient appropriate audit evidence for each of those opinion units with material net position accounts. (See the discussion of opinion units in chapter 4.) The nature, extent, and timing of audit procedures on the financial statement reconciliations would relate to the auditor's assessment of the risks of material misstatement for the governmental and business-type activities opinion units in the government-wide financial statements. The reconciliations explain the differences between (*a*) the total governmental funds and the governmental activities and (*b*) the total enterprise funds and business-type activities. Therefore, the reconciliations are not designed to relate to opinion units in the fund financial statements (such as individual major governmental funds).

10.29 AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), addresses the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements through understanding the entity and its environment, including the entity's internal control. The auditor may include controls over net position and its components and the financial statement reconciliations when performing risk assessment procedures. As such, the auditor should evaluate the design of the controls that are relevant to the audit and determine whether they were implemented. In addition to standard internal control features for net position, internal control features for net position and for the financial statement reconciliations that are unique or significant in government may include the following:

- A process for identifying and documenting net position and fund balance restrictions and nonspendable, committed, assigned, and unassigned fund balances
- Review and approval of documentation for net position and fund balance restrictions and nonspendable, committed, and assigned fund balances by appropriate personnel
- A process for identifying and authorizing the use of restricted, committed, or assigned resources
- Periodic review of nonspendable, restricted, committed, assigned, or unassigned net position accounts
- A process for identifying, documenting, and reviewing reconciling items between the fund and the government-wide financial statements and for presenting those reconciliations in accordance with GAAP
- A process for identifying, documenting, and reviewing required note disclosures for net position

10.30 In addition to standard audit procedures for net position, audit procedures for net position and for the financial statements reconciliations that are unique or significant in government may include the following:

- Reviewing policies and procedures related to fund balance classifications, stabilization arrangements, and minimum fund balance and determining they are properly disclosed in the financial statements
- Reviewing minutes of meetings of the governing body; constitution, charter, statutes, and ordinances; debt issuance documents; contribution and grant agreements; and other similar documents to identify the requirements and authorizations for net

position restrictions, commitments, assignments, or nonspendable amounts

- Reviewing appropriate documentation to support fund balance commitments and assignments
- Asking appropriate management personnel about the existence of net position restrictions, commitments, assignments, and nonspendable amounts
- Determining whether net position restrictions, commitments, assignments, and nonspendable amounts have been made in compliance with the applicable legal and contractual provisions and management policies
- Determining whether formal action (at the government's highest level of decision-making authority) to commit fund balance to a specific purpose occurred prior to the end of the reporting period
- Ascertaining that any specific amounts determined in the subsequent period, for which formal action to commit fund balance occurred prior to the end of the reporting period, were properly reported at the end of the reporting period
- Determining whether net position restrictions, commitments, assignments, and nonspendable amounts have been properly disclosed in the financial statements, the notes thereto, or both
- With respect to special revenue funds
    - — Determining that special revenue funds are established to account for and report the proceeds of specific revenue sources that are restricted or committed to expenditure for specified purposes (other than debt service or capital projects); conversely, determining that any funds accounting for the use of resources that do not meet this definition of a restricted or committed revenue are reported as part of the general fund or other fund type
    - — Determining that those restricted or committed revenue sources are reported directly in the special revenue fund (not in another fund first with an interfund transfer into the special revenue fund)
    - — Identifying the specific restricted or committed revenue sources accounted for and reported in special revenue funds
    - — Ascertaining that the restricted or committed proceeds of the specific revenue sources of special revenue funds are expected to continue to comprise a substantial portion of the inflows reported in the funds
    - — Determining that other resources accounted for and reported in special revenue funds have been restricted, committed, or assigned to the specified purpose of the fund
    - — Determining that the government has discontinued reporting a special revenue fund if it no longer expects that a substantial portion of the inflows will derive from restricted or committed resources and that the remaining

resources are reported in the general fund or as part of another fund with a similar purpose that does meet the criteria to be reported as a special revenue fund

- With respect to permanent funds
  - — Determining that only earnings and not principal were expended and only for the benefit of the government or its citizenry and for the purposes to which the earnings are restricted
  - — Ascertaining that the amount of corpus legally required to be maintained in perpetuity has been properly maintained
- Testing expenses or expenditures to determine that they are accounted for and reported in the proper fund
- Testing expenses or expenditures to determine that restricted, committed, or assigned resources are used (*a*) for their restricted, committed, or assigned purpose and (*b*) in accordance with management's policy regarding which resources are considered to be spent first for expenses or expenditures for which more than one resource classification is available
- Determining whether deficit fund balances or net position of individual nonmajor funds are properly disclosed in the financial statements
- Determining whether assigned fund balances create or increase a negative unassigned fund balance at year-end
- Determining that encumbrances have been properly excluded from unassigned fund balance
- Determining whether net position restrictions, commitments, or assignments or nonspendable amounts are removed if they are no longer required or relevant
- Analyzing changes to net position accounts for the year to determine whether they are properly reported in the financial statements or the notes thereto
- Evaluating whether the reconciling items between the fund and the government-wide financial statements are properly calculated and the reconciliations are properly presented

10.31 As discussed in chapter 2, the standards for selecting major funds could result in different funds being reported as major each year. Further, as discussed in chapter 4, the auditor should plan, perform, evaluate the results of, and report on the audit of each opinion unit and each major fund as a separate opinion unit. If the auditor did not audit a current-year major fund as major in the previous year, the auditor should consider the need to perform procedures on the opening net position balance of the fund to evaluate whether the net position amount is properly stated and supported by underlying assets and liabilities.

Chapter 11

The Budget

There are similarities, but important differences, between how GASB defines supporting information and how the AICPA auditing standards refer to that same information. The following is intended to clarify the two standard-setters' descriptions of the information and how the information will be referred to in the guide.

According to GASB Concepts Statement No. 3, *Communication Methods in General Purpose External Reports That Contain Basic Financial Statements*, supporting information places basic financial statements and notes to basic financial statements in an appropriate operational, economic or historical context. The information is either (1) required by GASB as required supplementary information (RSI) to be presented with the basic financial statements and the notes thereto; (2) supplementary information (SI), which is required by law or regulation to be presented; or (3) SI presented at the election of the preparer. SI as contemplated in GASB Concepts Statement No. 3 (preceding items 2–3) are referred to in this guide when describing GASB requirements as "*GASB defined*" *SI*. GASB Concepts Statement No. 3 limits its discussion of supporting information to "GASB defined" SI and RSI.

In contrast, the AICPA auditing standards refer to such supporting information as either RSI, other information (OI), or SI. AU-C section 730, *Required Supplementary Information* (AICPA, *Professional Standards*), defines RSI consistently with GASB literature. Therefore, references to such information in this guide are to RSI. AU-C section 720, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*), defines OI as financial and nonfinancial information (other than the financial statements and the auditor's report thereon) that is included in a document containing audited financial statements and the auditor's report thereon, excluding RSI. AU-C section 725, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*), defines SI as information presented outside the basic financial statements, excluding RSI that is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. This guide uses SI to describe information for which (1) the required conditions in AU-C section 725 have been met and (2) the auditor has been engaged to provide an "in relation to" opinion and OI for situations where the limited procedures in AU-C section 720 are required.

Introduction

11.01 Budgeting is an essential element of the financial planning, control, and performance evaluation processes of many governments. In contrast to commercial organizations' planning-oriented budgetary practices, governments usually adopt budgets that have the force of law, are subject to sanctions for overspending budgetary authorizations, and have extensive controls to ensure budgetary compliance. The budgeting requirements and practices followed by governments vary greatly, and the auditor's understanding of the entity and its environment, including its internal control, encompasses the laws and regulations governing the budgetary requirements of the government being audited, as well as the government's budget and budgetary process and policies. In addition to basic information about the budgetary process and policies, this chapter discusses

- the financial reporting requirements relating to budgetary comparison information.
- the auditor's responsibility for required budgetary comparison information, whether presented as RSI or as part of the basic financial statements.
- how performing audit procedures on an entity's budget may assist in the audit of financial statement accounts or be required to satisfy the auditor's responsibility for material misstatements arising from noncompliance with laws and regulations and provisions of contracts and grants.

11.02 State laws and regulations generally require general-purpose and some special-purpose governments to adopt budgets and to report on their actual results against those budgets for at least their general funds. Legal provisions also may require those entities to adopt and report on budgets for other funds, such as special revenue and debt service funds. Some governments, in particular special-purpose governments such as utilities, authorities, and colleges and universities, do not have legal provisions that require budgets or budgetary reporting, and they may not have legally adopted budgets, which are budgets that create legally enforceable limits on spending.

11.03 National Council on Governmental Accounting (NCGA) Statement 1, *Governmental Accounting and Financial Reporting Principles*, as amended; NCGA Interpretation 10, *State and Local Government Budgetary Reporting*, as amended; and GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, as amended are the primary standards for budgetary accounting and reporting. In NCGA Statement 1, as amended, the summary statement of principle regarding budgeting, budgetary control, and budgetary reporting states the following:

a. An annual budget(s) should be adopted by every governmental unit.

b. The accounting system should provide the basis for appropriate budgetary control.

c. Budgetary comparisons should be presented for the general fund and for each major special revenue fund that has a legally adopted annual budget.[1] Governments are encouraged to present such budgetary comparison information in schedules as a part of RSI. However, a government with significant budgetary perspective differences that result in the government's not being able to present budgetary comparisons for the general fund and each major special revenue fund is required to present budgetary comparison schedules as RSI based on the fund, organization, or program structure

[1] GASB *Implementation Guide No. 2015-1* (GASB IG 2015-1) question 7.91.10 clarifies that governments that budget on a biennial basis are not exempt from the requirement for budgetary comparison reporting. Further, question 7.91.13 explains that if the general fund does not have a legally adopted budget, the government should not present a budgetary comparison schedule (or statement) for the general fund. Finally, question 7.91.14 clarifies that a "legally adopted budget" requires that the government be unable to expend resources without it.

that the government uses for its legally adopted budget. The budgetary comparison schedules should present both (1) the original and (2) the final appropriated budgets for the reporting period as well as (3) actual inflows, outflows, and balances, stated on the government's budgetary basis.

Although the principle encourages the presentation of certain budgetary comparison information as RSI, footnote 53 of GASB Statement No. 34 paragraph 130, as amended, permits governments, except those subject to GASB Statement No. 41, *Budgetary Comparison Schedules—Perspective Differences—an amendment of GASB Statement No. 34*, as discussed in paragraph 11.12, to elect to report that information in a budgetary comparison statement as part of the basic financial statements.

Budgetary Processes

Types of Budgets[2]

11.04 As indicated previously, generally accepted accounting principles (GAAP) require the presentation of information about a government's legally adopted annual budgets for certain funds. Those presentations involve *appropriated budgets*, which is the expenditure authority created by the appropriation bills or ordinances that are signed into law and the related estimated revenues. An appropriated budget differs from a nonappropriated budget, which is "a financial plan for an organization, program, activity, or function approved in a manner authorized by constitution, charter, statute, or ordinance but not subject to appropriation and therefore outside the boundaries of the definition of 'appropriated budget'" (NCGA Interpretation 10 paragraph 11, as amended).

11.05 Governments may establish two types of budgets: monetary and performance. Monetary and performance budgets are not mutually exclusive. When one thinks of the term *budget*, one usually envisions a document and process that control governmental fund revenues and expenditures for a one-year period (or two separate annual periods, for those governments that budget on a biennial basis). That is a monetary budget. Many governments update their fixed, annual, monetary budgets periodically during the year as revenue estimates and expenditure needs change. The use of budgetary resources may be controlled at the program, department, fund, character, or object level, as discussed later in this chapter. Governments may develop monetary budgets for other purposes and periods, as follows:

- *Capital budgets.* These budgets usually are developed from a government's capital improvement program and adjusted for capital items that are not considered capital improvements (that is, vehicles, equipment, and so on). A capital improvement plan or a long-range capital plan presents estimates of expenditures for capital outlays and the proposed means of financing them. Capital budgets typically emphasize major capital outlay plans and usually are updated periodically as priorities change or unanticipated projects arise. Capital budgets help governments anticipate future changes in allowable debt levels and annual debt service

[2] Although this chapter discusses various types of budgets, the GASB requirements for presenting budgetary comparison information apply only to legally adopted budgets for the general fund and major special revenue funds.

requirements. Even if a government legally adopts a capital budget, GASB standards do not require the government to report budgetary comparison information about that budget because it is not an annual budget. However, the government may present budgetary comparison information for that budget as SI other than RSI, referred to in this guide as "*GASB defined*" *SI*.[3]

- *Proprietary fund flexible budgets.* The nature of most operations financed and accounted for through proprietary funds is such that the demand for the goods and services largely determines the appropriate level of revenues and expenses. Increased demand for the goods or services causes a higher level of expense to be incurred, but also results in a higher level of revenues. Thus, flexible budgets—prepared for several levels of possible activity—typically are used to plan, control, and evaluate proprietary fund spending. When formally adopted, the expense estimates of flexible budgets typically are not viewed as appropriations but as approved plans. A government evaluates and controls a flexible budget by comparing actual interim or annual revenues and expenses with planned revenues and expenses at the actual level of activity for the period. In some instances, however, legal provisions may require a fixed or flexible budget to be legally adopted for proprietary funds. Even if a government legally adopts a budget for proprietary funds, GASB standards do not require the government to report budgetary comparison information about that budget because presentation is only required for the general and major special revenue funds. However, the government may present budgetary comparison information for that budget as "GASB defined" SI.
- *Cash budgets.* A government will often prepare a cash budget when its revenues or expenses and expenditures, or both, are seasonal or otherwise cyclical in nature. A properly prepared cash budget will highlight periods where cash inflows exceed cash outflows and when projected cash outflows exceed cash inflows. This information is typically used in making short, intermediate, and long-term investing or borrowing decisions. When a government formally adopts a cash budget for its general and major special revenue funds, GASB standards do not require the government to report budgetary comparison information about that budget because presentation is only required for the appropriated budgets[4] for the general and major special revenue funds. However, the government may present budgetary comparison information for cash budgets as "GASB defined" SI.

11.06 Governments also may develop performance budgets in addition to or as part of monetary budgets. Performance budgets emphasize outputs,

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[3] This guide uses the term "*GASB defined*" *SI* to refer to supplementary information other than required supplementary information, which some governments present with their basic financial statements. See chapter 2, "Financial Reporting," for more information.

[4] National Council on Governmental Accounting Interpretation No. 10, *State and Local Government Budgetary Reporting*, paragraph 11, as amended by GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, defines this in relation to expenditure authority created by the appropriation bills, ordinances, and the like that are signed into law along with estimated revenues.

units of work performed, or services rendered within each budgeted program, such as tons of waste collected in the rubbish disposal program, rather than simply providing for the amounts to be spent. Performance budgets relate the input of resources to the output of services. Usually, performance budgets do not constitute legally adopted budgets.

Legal Level of Budgetary Control

11.07 Because of financial reporting and auditing considerations discussed later in this chapter, the auditor should understand the legal level at which budgetary control is exercised. The legal level of budgetary control is the level of detail at which the government's governing body appropriates resources. Below the legal level of budgetary control, the government's management can reassign resources without governing board approval. Common legal levels of budgetary control are as follows:

- *Program level.* A program-level budget allocates resources for particular activities or operations, regardless of the funds from which the resources are provided, the departments that spend the resources, or the types of items for which the resources are spent. For example, the governing board may establish a public safety program budget and control the use of resources at that level, even though several funds provide the resources and three departments—police, fire, and emergency medical services—charge various types of items to that program.
- *Department level.* A department-level budget allocates resources to a particular department or other organizational unit, regardless of the funds from which the resources are provided, the programs that department conducts, or the types of items for which the resources are spent. For example, a government may establish a budget for the public works department and control the use of resources at that level, even though that department spends resources from several funds for various types of items and conducts both road maintenance and garbage collection programs.
- *Fund level.* A fund-level budget allocates resources from an individual fund, regardless of the departments that spend the resources, the programs those departments conduct, or the types of items for which the resources are spent. For example, a government may establish a budget for its highway special revenue fund and control the use of resources at that level, even though that fund finances various types of items for both the highway and police departments and those departments' highway construction, maintenance, and safety programs.
- *Character level.* In addition to program-, department-, or fund-level budgets, the legal level of control may be further set by character, that is, on the basis of the fiscal period the use of resources are presumed to benefit. The major character classifications are current, which benefits the current fiscal period; capital outlays, which is presumed to benefit both the present and future fiscal periods; and debt service, which is presumed to benefit prior fiscal periods as well as current and future periods. Intergovernmental, a fourth character classification, is used when one government transfers resources to another, such as when states transfer

shared revenues to local governments or act as intermediaries in federally financed programs.

- *Object level.* Beyond character level, the legal level of control may be further set by object classes, that is, according to the types of items purchased or services obtained. Examples of current operating objects are personal services, supplies, and utilities. Capital outlays, debt service, and intergovernmental also are major object classifications.

11.08 In many governments, compliance with the legally adopted budget usually is required at the program, department, or fund level (or a combination of those levels), although some governments may use lower levels. Governments that establish the legal level of budgetary control at the program, department, or fund level also may monitor the use of budgetary resources at the character or object level, but this would be done to manage the use of budgetary resources rather than as a legal requirement. For example, a government may set the legal level of control at the departmental level but track each department's costs by object to provide useful information about how a given department spends its resources compared to the purposes for which it requested funding. However, as long as that department's total use of resources is not greater than the total budgeted level, noncompliance with budgetary requirements relating to the legal level of control would not exist. On the other hand, if the government is legally required to budget the use of resources at the object level, the fact that a given department's salaries exceed the amount budgeted for that object represents noncompliance with budgetary requirements relating to the legal level of control even though the department's total spending is less than the total amount budgeted.

Encumbrances

11.09 A component of budgetary control in governments is encumbrances, especially in general, special revenue, and capital projects funds. Encumbrances represent formal commitments (usually contracts or purchase orders) to acquire goods or services not yet received.[5] Encumbrances may be recorded in governmental fund accounts to lessen the risk that expenditures exceed appropriations. Encumbrances outstanding at year-end do not represent GAAP expenditures. Encumbered amounts for specific purposes for which amounts have not been previously restricted, committed, or assigned should not be classified as unassigned. Such encumbrances should be included within committed or assigned fund balance, as appropriate, based on the definitions of fund balance delineated in GASB Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*, as amended. However, disclosure of encumbrances, if significant, may be required as discussed in chapter 10, "Net Position and Financial Statement Reconciliations."

11.10 Some legal requirements may require encumbrances outstanding as of year-end to be considered expenditures and charged against current-year appropriations for budgetary reporting purposes. In those cases, encumbrances will be included with the expenditures reported in the budgetary comparison schedule or statement. In that situation, the difference between outstanding

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[5] Some governments also record preencumbrances when they intend to enter into contracts or issue purchase orders. Preencumbrances are control mechanisms and do not represent formal commitments.

encumbrances as of the beginning and end of the year should be a reconciling item between expenditures reported in the statement of revenues, expenditures, and changes in fund balances and those reported in the budgetary comparison schedule or statement, as discussed in paragraph 11.14. On the other hand, a legal requirement or formally adopted policy may require appropriations to automatically roll forward to cover prior-year outstanding encumbrances. In that case, the subsequent year's original budget presentation should include those appropriation amounts carried forward.

Budgetary Basis

11.11 NCGA Interpretation 10 paragraph 6 states that the scope and method of budgetary practices are outside the scope of financial reporting standards. Ideally, a monetary budget is prepared and executed using the same basis of accounting that is used in GAAP reporting for the same operations. However, in some cases, legal provisions will mandate a different budgetary basis. In those situations, NCGA Statement 1 paragraph 88 observes that governments typically (*a*) maintain the accounts and prepare budgetary reports on the legally prescribed budgetary basis to determine and to demonstrate legal compliance and (*b*) maintain sufficient supplemental records to permit presentation of financial statements in conformity with GAAP.

Financial Reporting Considerations

Budgetary Comparison Schedules or Statements

11.12 As mentioned in the introduction to this chapter, GASB Statement No. 34, as amended, requires budgetary comparisons to be presented for the general fund and for each major special revenue fund that has a legally adopted annual budget.[6] Some funds that are maintained as special revenue funds for accounting purposes do not meet the criteria for separate reporting in external financial statements and therefore should be presented as part of the general fund or a qualifying special revenue fund. Budgetary information relative to those funds should not be included in the general fund or qualifying special revenue fund budgetary comparison. The additional revenues and expenditures pertaining to the other funds result from perspective differences and should be explained in the reconciliation of budgetary information to GAAP information. (See the related discussion in question Z.54.41 in the GASB *Implementation Guide No. 2015-1* [GASB IG 2015-1]). Governments are encouraged to present such budgetary comparison information in schedules as a part of RSI. However, as provided in GASB Statement No. 41, a government with significant budgetary perspective differences that result in the government's not being able to present budgetary comparisons for the general fund and each major special revenue fund should present budgetary comparison schedules as RSI based on the fund, organization, or program structure that they use for their legally adopted budget. Those governments generally should present budgetary comparisons for the activities that are reported in the general fund and each major special revenue fund. The budgetary comparison schedules should present both the original and final appropriated budgets[7] for the reporting period as well as

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[6] See footnote 1.

[7] GASB Statement No. 34 paragraph 130, as amended, defines in detail the original and final appropriated budgets. Additional guidance is provided in paragraph 13 of the GASB IG 2015-1.

actual budgetary inflows, outflows, and balances stated on the government's budgetary basis. NCGA Interpretation 10 paragraph 14, as amended, requires individual fund budgetary comparisons to be presented at the legal level of budgetary control. If, for the funds or activities for which budgetary comparisons are required, the government presents budgetary comparisons at the legal level of control as "GASB defined" SI (for example, in a Comprehensive Annual Financial Report) or in a separate budgetary report that is referred to from the notes to RSI, the presentation of required budgetary comparison information in RSI may be made at a level that aggregates budgetary accounts through revenue source and expenditure function or program. GASB Statement No. 34, as amended, encourages governments to present a separate column in the schedules to report the variance between the final budget and the actual amounts. GASB Statement No. 34, as amended, also permits governments to present a separate column to report the variance between the original and final budget amounts. Governments may present the budgetary comparison schedules using the same format, terminology, and classifications as they use in their budget documents, or using the format, terminology, and classifications consistent with the statement of revenues, expenditures, and changes in fund balances. Budgetary comparison information for other funds, such as for nonmajor special revenue funds or for capital projects or debt service funds, may be presented as "GASB defined" SI, but not as RSI. (See the related discussions in questions 7.91.5 and 7.91.6 of the GASB IG 2015-1. Question 7.91.5 indicates that the consequence of presenting additional special revenue funds in the budgetary comparison schedule is that those funds are subject to all major fund reporting requirements and are, therefore, not considered nonmajor.)

11.13 GASB Statement No. 34 footnote 53, as amended, allows governments, except those subject to GASB Statement No. 41 as discussed in paragraph 11.12, to elect to report the required budgetary comparison information in a budgetary comparison statement as part of the basic financial statements, rather than as RSI.[8] If presented as a part of the basic financial statements, the required budgetary comparison information is subject to the same minimum information requirements and allowable formats as discussed in paragraph 11.12. Governments should not present budgetary comparison information in the basic financial statements for funds other than those for which GASB Statement No. 34, as amended, requires budgetary comparison information to be presented as RSI. Footnote 53 of GASB Statement No. 34, as amended, does not permit governments to present budgetary comparison information in the basic financial statements beyond that allowed if budgetary comparisons had been presented as part of RSI.

Disclosures

11.14 Notes to RSI should disclose excesses of expenditures over appropriations in individual funds presented in the budgetary comparison schedules. As with budgetary comparison information, this disclosure is based on the legal level at which budgetary control is exercised. Further, the budgetary comparison schedules should be accompanied by information (either in a separate schedule or in notes to RSI) that reconciles budgetary information to GAAP information. If the required budgetary comparison information is instead

[8] GASB Statement No. 34, as amended, encourages presentation of the budgetary comparison information as required supplementary information.

included in the basic financial statements, those disclosures should be included in the notes to the financial statements.

11.15 Regardless of whether the required budgetary comparison information is presented as RSI or as part of the basic financial statements, if the excess of expenditures over appropriations in any fund (including those funds that are not required to be presented in the budgetary comparison information) or any other noncompliance with budgetary legal provisions is considered a material violation of finance-related legal provisions, that violation should be disclosed in the notes to the financial statements as required by NCGA Statement 1 paragraph 11, as amended. (See this guidance discussed in question 7.93.1 of the GASB IG 2015-1.) In addition, the government should disclose actions taken to address such violations, as required by GASB Statement No. 38, *Certain Financial Statement Note Disclosures*, paragraph 9.

11.16 In certain circumstances, a budget is not adopted for the general[9] or a major special revenue fund because it is not legally required and, therefore, presentation of budgetary comparison information is not required. That situation should be disclosed in the notes to RSI to explain why what might appear to be required information is not part of the presentation. If the government chooses to present its required budgetary comparison information in the basic financial statements, that disclosure should be made in the notes to the financial statements.

Auditing Considerations

11.17 The extent of the auditor's responsibility over required budgetary comparison information depends in part on whether that information is presented as RSI or as part of the basic financial statements, as discussed in paragraphs 11.19–.21. Regardless of the method of presentation and the related audit responsibility, however, the auditor may perform audit procedures relating to a government's development and control of its budget to assist in the audit of certain financial statement accounts. (See paragraphs 11.22–.24.) Such audit procedures also may satisfy the auditor's responsibility for material misstatements arising from noncompliance with laws and regulations. (See paragraphs 11.25–.26.)

Internal Control Considerations

11.18 A legally adopted budget—which may take many forms, ranging from a single document that identifies all revenue sources and expenses or expenditures to numerous revenue and appropriation bills or ordinances—usually is the legal authority for the levy of taxes and the spending of moneys. Because of the legal importance of budgetary compliance and the consequences of budgetary noncompliance as described in paragraphs 11.01–.02, governments frequently have extensive internal control over their budgets. A government's internal control features relating to its budget may include the following:

- Segregation of duties between budget preparation, adoption, execution, and reporting

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[9] GASB IG 2015-1 question 7.91.13 explains that if the general fund does not have a legally adopted budget, the government should not present a budgetary comparison schedule (or statement) for the general fund.

- Controls over access to software applications that allow for modification of budgeted amounts
- The adoption and communication of procedures to establish authority and responsibility for budget development, approval, and amendments
- Integration of the budgeting system with the planning process and compatibility between the type of budgeting performed and the accounting system
- Preparation of the budget in sufficient detail to provide a meaningful tool with which to monitor subsequent performance
- A process to ensure that the original budget and any subsequent budgetary amendments receive governing body approval and are subjected to public notification and hearings, if required
- Formal integration of the budget into the accounting, budgeting, or procurement systems
- Periodic (monthly) comparison of actual revenues and expenditures to the budget, with explanation of and follow-up on significant variances
- Periodic reconciliation of recorded outstanding encumbrances to actual encumbrances outstanding
- Other processes and procedures to ensure adherence to relevant compliance requirements

Presentation of Budgetary Comparison Information

11.19 The auditor's responsibility for budgetary comparison information required by GASB to be presented as RSI is provided in AU-C section 730. As further discussed in chapter 4, "General Auditing Considerations," those responsibilities include applying certain limited procedures to the information, consisting principally of inquiries of management regarding the methods of measurement and presentation of the information and obtaining certain management representations. The auditor likely would perform those limited procedures while performing audit procedures because of his or her other auditing considerations as discussed in paragraphs 11.24–.26. That is, those audit procedures may likely encompass the limited procedures required for RSI under AU-C section 730. Chapter 16, "Audit Reporting," discusses the auditor's reporting responsibilities for RSI. Alternatively, the government may present the information as RSI and engage the auditor, under AU-C section 805, *Special Consideration—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement* (AICPA, *Professional Standards*), to render an opinion that the RSI is fairly presented, in all material respects, in accordance with GAAP.

11.20 As discussed in paragraph 11.13 and chapter 4, a government (except those subject to GASB Statement No. 41 as discussed in paragraph 11.12) may elect to present budgetary comparison information in the basic financial statements (thus subjecting it to audit coverage) for those funds for which the information is required to be presented as RSI—the general fund and each major special revenue fund that has a legally adopted budget. If the government makes this election, under AU-C section 700, *Forming an Opinion and Reporting on Financial Statements* (AICPA, *Professional Standards*), the auditor should perform audit procedures considered sufficient to express an opinion on whether the budgetary comparison information financial statement is fairly stated, in all material respects, in accordance with GAAP.[10] Additional procedures that the auditor might perform include detailed testing to determine whether the budgetary comparison statement or schedule and the notes thereto include the information required by GAAP for such presentations. (This additional procedure is in contrast with asking management whether the information is measured and presented within prescribed guidelines—one of the limited procedures for information presented as RSI under AU-C section 730.) The auditor might otherwise perform this type of audit procedure because of other auditing considerations as discussed in paragraphs 11.22–.24. Chapter 16 further discusses auditor reporting on budgetary information presented as a basic financial statement.

11.21 Budgetary comparison information, which is not required by GASB to be presented as RSI and which the auditor has not been engaged to issue an "in relation to" opinion, is considered OI as defined in AU-C section 720. Alternatively, a government could present such information as SI and engage the auditor to express an "in relation to" opinion under AU-C section 725. (Chapters 4 and 16 discuss the auditor's responsibilities for OI and SI.)

Audit Support for Financial Statement Assertions

11.22 An auditor may wish to perform audit procedures relating to an entity's budget to provide audit support for financial position and activity statement assertions. An auditor could consider, for example, controls to ensure that expenses or expenditures have been properly approved, monitored, and classified within the accounts to assist in the audit of those accounts. Unlike private-sector budgets, governmental budgets typically have the force of law, are integrated into the government's accounting structure, and are an integral part of the government's internal controls. The auditor should obtain an understanding of the controls that are relevant to the audit and evaluate their design and determine whether they have been implemented by performing procedures in addition to inquiry of the entity's personnel. If the auditor determines that those budgetary controls are in place and functioning properly, the auditor may be able to assess control risk for expenses or expenditures at low to moderate and use those controls as a basis for designing the nature, timing, and extent of substantive procedures. Some aspects of a governmental budgeting process could involve using nonfinancial information. If the required budgetary comparison information is presented as basic financial statements, the auditor should perform audit procedures relating to budgetary comparison statement assertions as discussed in paragraph 11.20. In those situations, the auditor's knowledge of the budgetary process and related controls should be sufficient to understand how

- the budget is developed and adopted.
- the budget is amended.
- the original budget and amendments are incorporated into the accounting system and the budgetary comparison statements.
- budgetary compliance is monitored and enforced.

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[10] The budgetary comparison information presented as part of the basic financial statements constitutes a third financial statement relating to each of the major fund opinion units for which it is presented. See the discussion of opinion units in chapter 4, "General Auditing Considerations."

11.23 Under AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), the auditor should perform analytical procedures as a risk assessment procedure. In addition, AU-C section 520, *Analytical Procedures* (AICPA, *Professional Standards*), addresses the auditor's use of analytical procedures as substantive procedures and the auditor's responsibility to perform analytical procedures near the end of the audit to assist when forming an overall conclusion on the financial statements. Analytical procedures that compare actual results to either the original or the final budget, or both, may be useful during the risk assessment phase of the audit.

11.24 In performing audit procedures relating to an entity's budget, the auditor should consider whether the government uses its budget to control spending or, instead, uses its spending to establish the budget. Some governments adopt a preliminary budget and amend it frequently, essentially allowing the budget to follow the results of operations. In that situation, audit procedures relating to the budget may not be very useful audit support for financial position and activity statement assertions.

Budgetary Compliance Considerations

11.25 As discussed in chapter 4, generally accepted auditing standards require the auditor to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements whether caused by fraud or error. According to paragraph .13 of AU-C section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* (AICPA, *Professional Standards*), the auditor should obtain sufficient appropriate audit evidence regarding material amounts and disclosures in the financial statements that are determined by the provisions of those laws and regulations generally recognized to have a direct effect on their determination. Further, the auditor should perform the following audit procedures that may identify instances of noncompliance with other laws and regulations that may have a material effect on the financial statements:

a. Inquiring of management and, when appropriate, those charged with governance about whether the entity is in compliance with such laws and regulations

b. Inspecting correspondence, if any, with the relevant licensing or regulatory authorities

In addition, the auditor should could consider material misstatements arising from budgetary noncompliance, regardless of whether the budgetary information is presented as part of the basic financial statements or as RSI, or is not required by GASB standards to be reported:

- Budgetary noncompliance could have a direct and material effect on the determination of financial statement amounts if budgetary comparison information is presented as part of the basic financial statements. For example, if the government's management amended the general fund budget without obtaining required governing board approval, the budgetary comparison statement's presentation of amended budget amounts would be misstated. The auditor should evaluate the effect of the noncompliance on the opinion on the general fund opinion unit. (See the discussions of opinion units in chapter 4.)

- Budgetary noncompliance could have a direct and material effect on the determination of financial statement amounts even if budgetary comparison information is not presented as part of the basic financial statements or is not required by GASB standards to be reported. For example, consider an entity's budget law that requires that it transfer any balance in excess of legally required reserves from a debt service fund to the general fund. If that transfer is not made, the auditor should evaluate the effect of the omitted transfer on the opinions on the affected opinion units. Further, the auditor may detect budgetary noncompliance that has a material indirect effect on the entity's financial statements. For example, if through inquiry and management representations, the auditor becomes aware that an entity does not adopt a legally required budget for a nonmajor special revenue fund and does not disclose the noncompliance in the notes to the financial statements, the auditor should evaluate the effect of the omitted disclosure on the opinion on the aggregate remaining fund information opinion unit.

11.26 The auditor should consider performing procedures to obtain an understanding of the laws governing the budgetary process and to determine whether budgets have been prepared and adopted in compliance with those requirements. Those audit procedures may include

- discussing with management or legal counsel the applicable legal provisions governing the budget and the budget's applicability to the various funds of the government.
- determining whether the budgetary process was performed in accordance with legal provisions, including those that require public notifications and hearings.
- reviewing the original budget and budgetary amendments for proper approvals.
- determining the legal level of budgetary control (that is, program, department, fund, character, or object, and the adequacy of the accounting system to operate at that level of control).
- determining the basis of accounting on which the budget is prepared.
- determining the budgetary basis of control (that is, expenditures only; expenditures and encumbrances; expenditures, encumbrances, and so on).
- evaluating whether expenditures in excess of appropriations in individual funds (*a*) constitute a material violation of legal provisions and (*b*) are appropriately disclosed.

Chapter 12

Special-Purpose and State Governments

There are similarities, but important differences, between how GASB defines supporting information and how the AICPA auditing standards refer to that same information. The following is intended to clarify the two standard-setters' descriptions of the information and how the information will be referred to in this guide.

According to GASB Concepts Statement No. 3, *Communication Methods in General Purpose External Reports That Contain Basic Financial Statements*, supporting information places basic financial statements and notes to basic financial statements in an appropriate operational, economic or historical context. The information is either (1) required by GASB as required supplementary information (RSI) to be presented with the basic financial statements and the notes thereto; (2) supplementary information (SI), which is required by law or regulation to be presented; or (3) SI presented at the election of the preparer. SI as contemplated in GASB Concepts Statement No. 3 (preceding items 2–3) are referred to in this guide when describing GASB requirements as *"GASB defined" SI*. GASB Concepts Statement No. 3 limits its discussion of supporting information to "GASB defined" SI and RSI.

In contrast, the AICPA auditing standards refer to such supporting information as either RSI, other information (OI), or SI. AU-C section 730, *Required Supplementary Information* (AICPA, *Professional Standards*), defines RSI consistently with GASB literature. Therefore, references to such information in this guide are to RSI. AU-C section 720, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*), defines OI as financial and nonfinancial information (other than the financial statements and the auditor's report thereon) that is included in a document containing audited financial statements and the auditor's report thereon, excluding RSI. AU-C section 725, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*), defines SI as information presented outside the basic financial statements, excluding RSI that is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. This guide uses SI to describe information for which (1) the required conditions in AU-C section 725 have been met and (2) the auditor has been engaged to provide an "in relation to" opinion and OI for situations where the limited procedures in AU-C section 720 are required.

Introduction

Update 12-1 *Fiduciary Activities*

GASB Statement No. 84, *Fiduciary Activities*, establishes criteria for identifying and reporting fiduciary activities. The criteria for identification of fiduciary activities primarily focuses on (a) whether a government controls the assets of the fiduciary activity and (b) the beneficiaries with whom a fiduciary relationship exists.

Governments with activities meeting the criteria will present a statement of fiduciary net position and a statement of changes in fiduciary net position, with certain exceptions.

There are four classifications of fiduciary funds described in GASB Statement No. 84: (1) pension (and other employee benefit) trust funds, (2) investment trust funds, (3) private-purpose trust funds, and (4) custodial funds. Custodial funds should report fiduciary activities that are not held in a trust or equivalent arrangement that meets specific criteria. Note that agency funds will no longer be reported upon application of this statement.

The statement was issued in January 2017 and is effective for fiscal years beginning after December 15, 2018. Earlier application is encouraged.

Upon its effective date, GASB Statement No. 84 will affect the guidance in this chapter.

The full text of the statement is available on GASB's website at www.gasb.org.

12.01 This chapter builds on the accounting, financial reporting, and auditing guidance elsewhere in this guide by providing specific guidance relating to certain types of governments, primarily special-purpose and state governments. All GASB pronouncements are potentially applicable to the financial statements of all governmental entities, including special-purpose governments, recognized Indian tribes that apply governmental accounting and financial reporting guidance, and states. Auditors should consider the "scope and applicability" section of each GASB pronouncement for specific applicability as well as the accounting, financial reporting, and auditing guidance in the other chapters of this guide.

12.02 *Special-purpose governments* are legally separate entities that perform only one activity or only a few activities, such as cemetery districts, school districts, colleges and universities, utilities, hospitals and other health care organizations, and public employee retirement systems (PERSs). Special-purpose governments are legally separate entities and may be primary governments, stand-alone governments,[1] or component units as defined in GASB Statement No. 14, *The Financial Reporting Entity*, as amended, and discussed in chapter 3, "The Financial Reporting Entity."

12.03 Auditors of special-purpose governments should be aware of and should consider consulting other AICPA Audit and Accounting Guides for accounting and auditing guidance as discussed in chapter 1, "Overview and Introduction," that are applicable to an audit of a governmental entity.[2] Audit Risk

[1] Stand-alone governments, which include joint ventures, jointly governed organizations, and pools, often are special-purpose governments. Examples of entities that may be joint ventures and jointly governed organizations are regional transportation authorities, water treatment plants, solid waste facilities, tax bureaus, airports, and libraries. Examples of pools are public entity risk pools and governmental external investment pools.

[2] The accounting and financial reporting guidance in the AICPA Audit and Accounting Guide *Not-for-Profit Entities* does not constitute category B accounting and financial reporting guidance for governmental entities because the AICPA did not make that guide applicable to those entities and GASB did not clear the guidance therein. (See the further discussion in footnote 27.) However, even though that guide is not applicable to governmental entities, auditors could consider referring to it for specific auditing considerations because many similar activities are conducted by governmental entities and not-for-profit organizations. The relevance to governmental audits of the other AICPA Audit and Accounting Guides referred to in chapter 1, "Overview and Introduction," is discussed elsewhere in this chapter.

Alerts, which are issued as complements to those guides, may help the auditor understand and apply the Statements on Auditing Standards. This chapter discusses how certain sources of accounting guidance fit into the hierarchy of generally accepted accounting principles (GAAP) for governmental entities. Chapter 1 discusses the GAAP hierarchy for governments.

Financial Reporting Requirements for Special-Purpose Governments

12.04 All legally separate special-purpose governments, whether primary governments, stand-alone governments, or component units of a primary government, should prepare basic financial statements, including the notes thereto, accompanied by all appropriate RSI, including a management's discussion and analysis (MD&A). (See National Council on Governmental Accounting [NCGA] Statement 1, *Governmental Accounting and Financial Reporting Principles*, paragraph 135, as amended, for the requirements relating to a government's issuance of annual financial reports.) GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, paragraphs 134–141, as amended, provides standards for the basic financial statements of special-purpose governments (as discussed in the following paragraph) that are designed to be appropriate to the nature and mix of the activities they perform.[3] Additional details about the basic financial statements for special-purpose governments are in paragraph 13 of the GASB *Implementation Guide* No. 2015-1 (GASB IG 2015-1). In performing an audit of a special-purpose government, an auditor should evaluate whether the entity has presented the appropriate basic financial statements and RSI. (Chapter 4, "General Auditing Considerations," and chapter 16, "Audit Reporting," discuss the auditor's responsibility for and reporting on RSI.)

12.05 Special-purpose governments that have only governmental activities (such as some library districts) or a combination of governmental and business-type activities[4] (such as some school districts) should present the same basic financial statements as would a general-purpose government. That is, they should present both government-wide financial statements and fund financial statements.

12.06 Special-purpose governments engaged in a single governmental program (such as some cemetery and fire districts) may present their government-wide and fund financial statements in one of the two alternate ways described in the following list.

- First, the government-wide and fund financial statements could be combined with a reconciliation of the individual line items in a separate column on the financial statements.
- Second, the government-wide and fund financial statements could be presented separately, but the government-wide statements of activities could be presented using a different format. For example, that statement could be presented in a single column that

[3] See chapter 2, "Financial Reporting," for the basic financial statements required for a general-purpose government. That chapter also provides an overview of required supplementary information (RSI). Various chapters of this guide discuss note disclosure requirements.

[4] GASB's definitions of *governmental activities* and *business-type activities* are discussed in chapter 2.

reports expenses first, followed by revenues (by major sources). The difference between those amounts is net revenue (expense) and should be followed by contributions to permanent and term endowments, special and extraordinary items, transfers, and beginning and ending net position.

A government is not considered to be engaged in a single governmental program if it budgets, manages, or accounts for its activities as multiple programs. For example, a school district that budgets, manages, or accounts for regular instruction, special instruction, vocational education, and adult education as separate programs is not engaged in a single governmental program.

See the illustrative financial statements in the nonauthoritative appendix B7-2 to the GASB IG 2015-1.

12.07 Special-purpose governments engaged only in business-type activities should present the financial statements required for enterprise funds: a statement of net position; a statement of revenues, expenses, and changes in net position; and a statement of cash flows.[5] In addition, the financial statements of special-purpose governments engaged only in business-type activities should measure, recognize, and report transactions and balances using proprietary fund accounting and financial reporting standards as provided in GASB pronouncements and this guide. This requirement could affect special-purpose governments that reported as of June 30, 1999, using the AICPA not-for-profit model, as defined in GASB Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*. GASB Statement No. 34, as amended, permits those entities to use enterprise fund accounting and financial reporting, even if they do not meet the statement's criteria for reporting as an enterprise fund. GASB Statement No. 34 paragraph 123 encourages special-purpose governments engaged only in business-type activities to present a statement of activities as SI other than RSI, referred to in this guide as *"GASB defined" SI*.[6] (Chapters 4 and 16 discuss the auditor's responsibility for and reporting on OI and SI under AU-C sections 720 and 725, respectively.)

12.08 Special-purpose governments engaged only in fiduciary activities should present the financial statements required for fiduciary funds: a statement of fiduciary net position and a statement of changes in fiduciary net position. The financial statements of special-purpose governments engaged only in fiduciary activities should measure, recognize, and report transactions and balances using fiduciary fund accounting and financial reporting standards as provided in GASB pronouncements and this guide.

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[5] Some special-purpose governments engaged only in business-type activities may report fiduciary activities in fiduciary funds. GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, as amended, does not require those governments to present a government-wide financial statement because the activity reported in fiduciary funds is not part of government-wide financial statements. Question 7.97.3 of the GASB *Implementation Guide* 2015-1(GASB IG 2015-1) indicates that a special-purpose government engaged only in business-type activities that has discretely presented component units that are engaged in governmental activities should present government-wide statements. Question 4.28.10 of the GASB IG 2015-1 discusses alternative presentations for a multiple-fund, special-purpose government engaged only in business-type activities that has a discretely presented component unit that is engaged in business-type activities.

[6] This guide uses the term *"GASB defined" SI* to refer to supplementary information (SI) other than RSI, which some governments present with their basic financial statements. See chapter 2 for more information.

12.09 Chapter 4, chapter 15, "Concluding the Audit," and chapter 16 discuss the nature and effect of opinion units in planning, performing, evaluating the results of, and reporting on the audit of a government's basic financial statements. In an audit of a special-purpose government that has only governmental activities or a combination of governmental and business-type activities, the opinion units normally are the governmental activities, the business-type activities, each major governmental and enterprise fund, and the aggregate remaining fund information (consisting of the nonmajor governmental and enterprise funds, the internal service funds, and the fiduciary funds), as applicable. (As discussed in chapter 4, in certain circumstances, auditors may choose to combine the two aggregate opinion units—the one for the aggregate discretely presented component units and the one for the aggregate remaining fund information—into a single opinion unit referred to as the *aggregate discretely presented component unit and remaining fund information opinion unit*.) In audits of special-purpose governments engaged only in business-type activities and that present more than one enterprise fund (such as a utility district that provides water, sewer, electrical, and trash services), the opinion units are each major enterprise fund and the aggregate nonmajor enterprise funds, if any, which represents the "aggregate remaining fund information."[7] In audits of special-purpose governments engaged only in fiduciary activities and that present more than one fiduciary fund or fund type (such as a PERS with more than one defined benefit pension plan administered through a trust or equivalent arrangement that meets specified criteria), the aggregate fiduciary funds are a single opinion unit that represents, in effect, "remaining fund information." In addition, a government's aggregate discretely presented component units should be a separate opinion unit. For all opinion units, including the aggregate opinion units, the auditor should consider quantitative and qualitative factors in determining the nature, timing, and extent of procedures on the various accounts within the opinion unit, as discussed in chapter 4. Chapter 4 also discusses how the terms of the engagement may require the auditor to set the scope of the audit and assesses materiality at a more detailed level than by the opinion units required for the basic financial statements.

Compliance Requirements

12.10 Governments are subject to various legal and contractual provisions (compliance requirements) arising from, for example, federal, state, and local laws; grants, contributions, and appropriations from other governments; and debt covenants. The auditor should consider whether it is necessary to evaluate the entity's compliance with those requirements as part of the financial statement audit. AU-C section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* (AICPA, *Professional Standards*), addresses the auditor's responsibility to consider laws and regulations in an audit of financial statements.[8] Chapter 4 discusses the auditor's responsibility, under

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[7] If a special-purpose government engaged only in business-type activities reports fiduciary activities in fiduciary funds, the fiduciary funds are part of the aggregate remaining fund information opinion unit.

[8] AU-C section 935, *Compliance Audits* (AICPA, *Professional Standards*), is applicable when an auditor is engaged, or required by law or regulation, to perform a compliance audit in accordance with (*a*) generally accepted auditing standards, (*b*) standards for financial audits under *Government Auditing Standards*, and (*c*) a governmental audit requirement that requires an auditor to express an opinion on compliance. AU-C section 935 does not apply to the financial statement audit that may be performed in conjunction with a compliance audit. See the AICPA Audit Guide Government Auditing Standards *and Single Audits* for more information.

AU-C section 250, to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatements arising from noncompliance with provisions of laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements. It also describes the auditor's responsibility regarding the provisions of laws and regulations that do not have a direct effect on the determination of material amounts and disclosures in the financial statements but compliance with which may be fundamental to the operating aspects of the business, fundamental to an entity's ability to continue its business, or necessary for the entity to avoid material penalties.

Specific Guidance for Special-Purpose Governments[9]

Hospitals and Other Health Care Providers[10]

12.11 There are various differences between the accounting and financial reporting standards for hospitals and other health care providers that are governments and those that are not governmental. The listing at paragraph 12.65 highlights many of those differences. Auditors should become familiar with governmental standards for hospitals and other health care providers as discussed in this section and elsewhere in this guide when performing audits for those entities.

12.12 Generally, governmental hospitals and other health care providers use enterprise fund accounting and financial reporting. If a hospital or other health care provider does not meet the criteria in GASB Statement No. 34 paragraph 67, requiring the use of enterprise funds (as discussed in chapter 2, "Financial Reporting"), it may use either governmental fund or enterprise fund accounting and financial reporting. Often, governments do not use enterprise funds to report activities relating to the long-term institutional care (which includes health care) of the elderly, children, and the mentally impaired because they do not meet the criteria requiring the use of enterprise funds and because user fees are not a principal revenue source for the activity. Governmental hospitals and other health care providers may have component units. (Chapter 3 discusses the provisions of GASB Statement No. 14, as amended, including the provisions of GASB Statement No. 39, *Determining Whether Certain Organizations Are Component Units—an amendment of GASB Statement No. 14*. The nonauthoritative appendix B4-2 of the GASB IG 2015-1 provides an example that evaluates a potential component unit for a hospital using GASB Statement No. 39 criteria.) The auditor should apply the concept of opinion units in planning, performing, evaluating the results of, and reporting on audits of governmental hospitals and other health care providers, as discussed in paragraph 12.09. Governmental hospitals and other health care providers are subject to various legal and contractual provisions that may affect their financial statements. As discussed in paragraph 12.10, the auditor should consider whether it is necessary to evaluate the entity's compliance with those requirements as part of the financial statement audit.

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[9] Although this section is written in terms of special-purpose governments, the accounting, financial reporting, and auditing considerations are usually equally applicable when the activity is conducted as a function or program of a general-purpose government.

[10] See also the discussion of Medicaid in the section of this chapter titled "Specific Guidance for State Governments."

12.13 As discussed in chapter 1, the AICPA Audit and Accounting Guide *Health Care Entities* includes in its scope governmental health care organizations when they issue separate financial statements using enterprise fund accounting and reporting.[11] Chapter 15, "Unique Considerations of State and Local Government Health Care Entities" of the Audit and Accounting Guide *Health Care Entities* includes category B accounting and financial reporting guidance for those governmental health care organizations. (See chapter 1 for a discussion of the GAAP hierarchy for governments.) The remainder of that guide has not been cleared by GASB and, therefore, has not specifically been made applicable to governmental entities. However, it provides specific accounting and auditing considerations that are unique to or prevalent in the health care industry. This guide, however, contains information about governmental accounting and financial reporting standards and other matters that are unique to or prevalent in government and not included in Audit and Accounting Guide *Health Care Entities*. The most potentially relevant matters for the financial statements of legally separate governmental hospitals and other health care providers are in the section of this chapter titled "Financial Reporting Requirements for Special-Purpose Governments," the "Auditing Considerations" sections of other chapters, chapters 4, 15–16, and 18, "Auditor Involvement With Municipal Securities Filings," and appendix B, "Category B Guidance." Also particularly applicable may be the discussions in chapter 8, "Expenses or Expenditures and Liabilities," on unrelated business income taxes (UBIT) and fund-raising costs.

School Districts

12.14 School districts and charter schools provide elementary and secondary education programs. Depending on state laws, school districts and charter schools generally operate as (*a*) part of the legal entity of the sponsoring government,[12] (*b*) primary governments, (*c*) stand-alone governments, or (*d*) legally separate entities that are component units of another government. School districts also may have component units. (Chapter 3 discusses the provisions of GASB Statement No. 14, as amended, including the provisions of GASB Statement No. 39. The nonauthoritative appendix B4-2 of the GASB IG 2015-1 provides examples that evaluate potential component units for school districts using GASB Statement No. 39 criteria.) As discussed in paragraphs 12.05–.06, legally separate school districts usually present both government-wide and fund financial statements. The auditor should apply the concept of opinion units in planning, performing, evaluating the results of, and reporting on audits of school districts, as discussed in paragraph 12.09.

Compliance Requirements

12.15 School districts are subject to various legal and contractual provisions, including state-established accounting and reporting requirements, that may affect their financial statements. For example, many states require their

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[11] Even though the AICPA Audit and Accounting Guide *Health Care Entities* applies only to governmental health care organizations when they issue separate financial statements using enterprise fund accounting and reporting, auditors could consider referring to that guide in other financial reporting situations for specific auditing considerations relating to governmental health care organizations (such as, for example, audit procedures relating to amounts due from discharged patients and third-party payors).

[12] School districts that are part of the legal entity of a sponsoring government sometimes issue separate individual fund or departmental financial statements, as discussed in chapter 16, "Audit Reporting."

school districts to use standardized charts of accounts for their basic financial statements and for special-form annual reports. As discussed in paragraph 12.10, the auditor should perform the audit procedures described in paragraph .14 of AU-C section 250 for the purpose of identifying instances of noncompliance with laws and regulations that may have a material effect on the financial statements and consider whether it is necessary to evaluate the district's compliance with those requirements as part of the financial statement audit.

Attendance Reporting

12.16 Most school districts receive financial assistance from state governments based on some measure of student attendance. Attendance data also may affect the amount of certain types of federal awards. Attendance data typically are determined at individual schools and reported on a district-wide basis. Some states may require auditors to audit or otherwise perform procedures on attendance data. Those engagements should be performed under the provisions of Statements on Standards for Attestation Engagements. See AT-C section 315, *Compliance Attestation* (AICPA, *Professional Standards*), for additional guidance. Further, the auditor should follow the guidance in AU-C section 250 if incorrect data in a district's attendance reporting, as part of the audit of the district's financial statements, could have a material effect on the financial statements. (In some cases, a school district's attendance reporting does not have a material effect on the current year's financial statements but, rather, affects the calculation of state and federal subsidies in a future period.)

Summer Payroll

12.17 Some school districts pay teachers on a 12-month basis for services during the 9-month academic year. Because payroll costs are exchange transactions that should be recognized when the employees provide the services, school districts should accrue expenses or expenditures and liabilities at year-end for salaries earned but not yet paid. Some school districts with June 30 fiscal year-ends facilitate that expense or expenditure accrual by writing the checks for summer payroll as of year-end and holding them for later distribution. In those situations, the auditor could evaluate the internal control over the safeguarding and subsequent distribution of those checks and controls regarding proper recording for the amounts to be paid during the remaining months.

Student Activity Funds

12.18 Most school districts have petty cash or bank accounts for student-generated moneys. In some cases, those amounts may be under the control of individual school principals or employees and not subject to the district's budgetary or centralized accounting and purchasing controls. States have different legal provisions for how the amounts in student activity funds may or should be used. Student activity funds should be reported in a district's financial statements as, for example, special revenue (if specific criteria are met) or agency funds, depending on the nature of the requirements concerning the use of the moneys. A district's student activity funds may be of concern to an auditor despite the small amounts involved because of the opportunity for misappropriation. Many receipts are in the form of cash and may be handled by several persons after the district becomes accountable for the amounts but before they are deposited. Adverse publicity can result from a loss or misuse of the moneys. Therefore, the auditor could evaluate the internal control over and the use of the moneys. However, a district's accountability for student activity moneys may differ depending on state law and the nature of the fund-raising activity. For example, a school district may be accountable for gate receipts for functions held on its campus, but not accountable for receipts from an off-campus fund-raising activity until a district employee or official takes custody of the moneys.

Child Nutrition Programs

12.19 Most school districts participate in U.S. Department of Agriculture (USDA) programs that provide cash and commodities to provide nutritious meals to students. The auditor should consider whether it is necessary to evaluate a district's compliance with the USDA's regulations for those programs as part of the financial statement audit and follow the guidance in AU-C section 250. Revenue for the cash portion of those programs should be recognized using the provisions of GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, as amended, as described in chapter 6, "Revenues and Receivables." Food commodities are within the scope of GASB Statement No. 33, as amended, and should be recognized as revenue in the period when all eligibility requirements are met (typically, when the commodities are received). Further, some states have established specific accounting and financial reporting requirements for child nutrition programs.

Charter Schools

12.20 Many states have laws permitting the creation of charter schools, which are publicly funded, nonsectarian schools that operate free of many of the regulations, restrictions, and mandates of traditional public schools. State laws define the organizations that grant the charters (usually local school districts or the state department of education) as well as eligible applicants (usually governmental or not-for-profit entities or one or more persons or organizations). Charter schools are commonly established under law and contract as separate legal entities and are accountable for their results at the end of the contract period, which is usually three to five years in length. Per-student state and local funds generally follow students to a charter school. Depending on legal and contractual provisions, a charter school may be a governmental or nongovernmental entity, and may be a component unit of a governmental entity. (See the definition of *governmental entities* in chapter 1.) Standardized accounting and financial reporting requirements that states have developed for public schools also may apply to charter schools.

Airports

12.21 Generally, governmental airports are reported using enterprise funds. If an airport does not meet the criteria in GASB Statement No. 34 paragraph 67, requiring the use of enterprise funds (as discussed in chapter 2), it may use either governmental fund or enterprise fund accounting and financial reporting. The auditor should apply the concept of opinion units in planning, performing, evaluating the results of, and reporting on audits of governmental airports, as discussed in paragraph 12.09. Airports are subject to various legal and contractual provisions that may affect their financial statements. For example, provisions of grants from the U.S. Federal Aviation Administration (FAA) may require that the airport's revenues and other resources be used only for on-airport purposes and not be diverted to off-airport uses. As discussed in paragraph 12.10, the auditor should consider whether it is necessary to evaluate the airport's compliance with those requirements as part of the financial statement audit and follow the guidance in AU-C section 250.

12.22 Some airports receive revenues from passenger facility charges (PFCs), which are small-dollar passenger enplanement fees that airports charge to help pay for capital development projects. An airport is required to receive approval from the FAA to impose PFCs and to comply with the FAA's requirements for the use of PFCs. Airlines collect PFCs through the ticket sales process and remit them to the appropriate airports. Federal regulations require an audit of PFCs, and the FAA's *Passenger Facility Charge Audit Guide for Public Agencies* provides auditors with the procedures for auditing and reporting on PFCs received and expended by airports.

12.23 GASB Statement No. 34 paragraph 102 indicates that PFCs normally would not be reported as components of operating income in a proprietary fund's statement of revenues, expenses, and changes in fund net position. Further, PFCs are identified in paragraph 102 of GASB Statement No. 34 and in the nonauthoritative "Basis for Conclusions" of GASB Statement No. 33 (paragraph 50) as exchange-like transactions, and, thus, revenue recognition should be based on the occurrence of the exchange (that is, the passenger enplanement). Therefore, the auditor could evaluate whether PFCs have been properly classified and recognized in the financial statements.

Public Housing Authorities

12.24 Public housing authorities (PHAs) provide shelter to low-income persons and generally receive substantial capital and operating grants from the U.S. Department of Housing and Urban Development (HUD). PHAs provide shelter by owning and managing housing developments, generally referred to as the low-income program. They also provide shelter through Section 8 programs by giving participants vouchers for rent subsidies that permit them to locate their own housing and by paying rent subsidies directly to private landlords. In addition, PHAs may finance low-interest mortgages and engage in urban renewal activities. Depending on state and local laws, PHAs, including those of recognized Indian tribes, generally operate as (*a*) departments of the sponsoring government, (*b*) stand-alone governments, or (*c*) legally separate entities that are component units of another government. Legally separate PHAs may be created by a single sponsoring government. Alternatively, they can be created as joint ventures of several governments or as independent regional authorities.

12.25 Generally, PHAs are reported using enterprise funds. If a PHA does not meet the criteria in GASB Statement No. 34 paragraph 67 requiring the use of enterprise funds (as discussed in chapter 2), it may use either governmental fund or enterprise fund accounting and financial reporting. The auditor should apply the concept of opinion units in planning, performing, evaluating the results of, and reporting on the audits of PHAs, as discussed in paragraph 12.09.

12.26 HUD has established *Uniform Financial Reporting Standards* and written guidelines that require PHAs that own HUD-assisted housing to submit financial information electronically to HUD using a template known as the Financial Data Schedule (FDS). For purposes of those submissions, HUD requires PHAs to prepare their basic financial statements in accordance with GAAP and to have those financial statements audited. HUD also requires PHAs to include the FDS as SI that accompanies their basic financial statements and for auditors to evaluate whether that data is fairly presented in relation to the basic financial statements. (Chapters 4 and 16 discuss the auditor's responsibility for and reporting on SI.) HUD also requires a PHA to obtain an agreed-upon procedures engagement in which the auditor compares the authority's electronically submitted data to the hard copies of the audit report and FDS.

12.27 The auditor should obtain an understanding of the various federal housing grant program requirements as well as other compliance requirements that affect the PHA, and consider whether it is necessary to evaluate the authority's compliance with those requirements as part of the financial statement audit.[13] (See paragraph 12.10.) In addition, the auditor might consider confirming directly with HUD the operating subsidies, program grants, and loans and other housing development and modernization debt relating to the PHA to evaluate whether receivable and revenue amounts are properly recognized and reported.

Financing Authorities

12.28 Many governmental entities establish financing authorities to make loans to specific types of recipients. The purpose of those loans is to lower the costs of borrowing for the recipients while advancing or achieving some public purpose. Sometimes the recipients of those loans are members of special-interest groups (for example, as with an authority that provides loans to veterans, farmers, or low-income homeowners). Sometimes those recipients are other governmental entities or not-for-profit organizations (for example, a school or hospital financing authority that provides loans for new facilities). Sometimes those recipients are for-profit entities (for example, an economic or industrial development authority that provides loans for plant expansion, thereby increasing a community's employment level and tax base). Financing authorities typically issue revenue bonds to finance their activities. (Tobacco Settlement Authorities [TSAs] are financing authorities. See the discussion of the accounting and financial reporting requirements for TSAs in the section of this chapter titled "Specific Guidance for State Governments.")

12.29 Financing authorities generally meet the provisions in GASB Statement No. 34 paragraph 67, requiring reporting as an enterprise fund (as discussed in chapter 2). If a financing authority does not meet the criteria requiring the use of enterprise funds, it may use either governmental fund or enterprise fund accounting and financial reporting. The auditor should apply the concept of opinion units in planning, performing, evaluating the results of, and reporting on audits of financing authorities, as discussed in paragraph 12.09.

12.30 If an authority finances the purchase or construction of capital assets for other entities, it generally takes title to the assets and leases them to the recipients. Ownership of the assets passes to the lessees when the bonds mature and are retired. The lease or loan payments the authority receives are used to pay the revenue bond principal and interest. Authorities typically charge, to the entities benefiting from the debt issue, fees in excess of the amounts required

[13] U.S. Department of Housing and Urban Development (HUD) grant agreements typically include a number of requirements with which the recipient (that is, a governmental entity in the context of this guide) must comply. Some of the compliance requirements may relate to transactions, projects, or activities that span more than one financial reporting period (for example, construction projects, construction loans, beneficiary loan programs, and so on). Other times, HUD grant agreements may require matching efforts on the part of the recipient or may involve noncash transactions (for example, use of a building, supplying of grant-related services by HUD personnel, and so on).

for bond principal and interest payments to finance the authority's administrative costs. In some cases, financing authorities develop a permanent capital base that is used for making loans and, occasionally, grants to recipients. The accounting, financial reporting, and auditing considerations for capital leases when a government is the lessor are discussed in chapter 7, "Capital Assets." See also paragraph 12.32 concerning leases between a primary government and its component units.

12.31 Many authorities that finance capital assets often do not become directly involved in either purchasing or constructing the assets or repaying the debt. A financial institution acting as trustee usually administers the debt service. In such cases, practice supports (*a*) reporting the debt and related capital lease receivable in the authority's financial statements or (*b*) disclosing the debt and related capital lease receivable in the notes to the financial statements; the authority should report in its financial statements fees and administrative expenses. See chapter 8 for a further discussion of this type of debt—known as *conduit debt*—and the disclosures required by GASB Interpretation No. 2, *Disclosure of Conduit Debt Obligations—an interpretation of NCGA Statement 1*, as amended.

12.32 Sometimes, a government may create a financing authority solely to finance its own capital assets, such as state office buildings or university dormitories. In those situations, the sponsoring government usually creates the authority to shield the borrowing from its own debt limits or other debt restrictions. The authority generally issues revenue bonds, takes title to the assets and leases them to the sponsoring government, and uses the lease payments to repay the debt principal and interest. If legally separate entities, those authorities are component units of the sponsoring governments. NCGA Statement 5, *Accounting and Financial Reporting Principles for Lease Agreements of State and Local Governments*, paragraphs 22–26, as amended, and GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, as amended, specify the accounting and financial reporting in the reporting entity financial statements for lease agreements between related parties including primary governments and public authorities that are part of the primary government's legal entity or a component unit. That accounting and financial reporting depends on whether the authority is presented in the reporting entity financial statements as part of the primary government (including as a blended component unit) or, instead, as a discretely presented component unit[14] (see the criteria for component units, blended component units, and discretely presented component units in chapter 3):

- If the authority is reported as part of the primary government's financial statements (including as a blended component unit), the criteria of paragraphs 211–271 of GASB Statement No. 62, as amended, do not apply to the lease agreement in the reporting entity financial statements. Instead, the authority's debt and assets should be reported as a form of the primary government's debt and assets. For example, the leased assets would be reported as

[14] If the public authority is not a component unit, accounting and financial reporting for lease agreements between the authority and the lessee government should be treated in the same manner as any other lease agreement of a state or local government, using the criteria of GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, as amended.

general capital assets, and the related debt would be reported as a general long-term liability in the government-wide statement of net position. The debt service activity of the authority would be reported as a debt service activity of the primary government.

- If the authority is a discretely presented component unit, the lease arrangement should be treated in the same manner as any other lease agreement of a state or local government using the provisions in GASB Statement No. 62, as amended. However, related capital lease receivables and payables should not be combined with other amounts due to or from discretely presented component units, or with capital lease receivables and payables with organizations outside of the reporting entity. For additional guidance on accounting, financial reporting, and auditing for lease transactions, see chapter 8.

12.33 NCGA Statement 5 paragraph 26, as amended, requires that when lease arrangements exist between state and local governments and public authorities, the related-party considerations of GASB Statement No. 62 paragraphs 239–240 should be considered to determine if there are special reporting and disclosure requirements. GASB Statement No. 62 paragraph 239, provides that "the classification and accounting should be the same as for similar leases between unrelated parties, except in cases where it is clear that the terms of the transaction have been significantly affected by the fact that the lessee and lessor are related." That paragraph further provides that "the classification and accounting should be modified as necessary to recognize economic substance rather than legal form" and that "the nature and extent of leasing transactions with related parties should be disclosed." See chapters 3–4 and 15–16 of this guide for additional discussion of concerns and reporting issues associated with related party transactions.

12.34 Finance authorities are subject to various compliance requirements. The auditor should consider whether it is necessary to evaluate an authority's compliance with those requirements as part of the financial statement audit and follow the guidance in AU-C section 250. (See paragraph 12.10.) Further, the accounting and financial reporting guidance in the AICPA Audit and Accounting Guide *Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies, and Mortgage Companies* does not constitute category B accounting and financial reporting guidance for financing authorities because the AICPA did not make that guide applicable to governmental entities and GASB did not clear any of the guidance therein. However, even though that guide does not apply to financing authorities, auditors may refer to it for specific auditing considerations relating to financing authorities (such as, for example, audit procedures relating to the allowance for loan losses).

12.35 GASB Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues*, as amended, discusses exchanges by governments of interests in their expected cash flows from collecting specific receivables or specific future revenues for immediate cash payments. The statement provides standards for determining whether such exchanges should be classified as sales or as collateralized borrowing transactions and, among other topics, discusses sales of mortgages and student loan receivables issued by state financing authorities. The statement further provides that assets and future revenues transferred in an intra-entity transaction should be reported at their carrying value; that is, they should not be revalued.

Transportation Systems

12.36 Legally separate transportation systems (which provide subway, bus, rail, or some other transportation service) may be created by a single sponsoring government, as joint ventures of several governments, or as independent regional authorities. A significant accounting, financial reporting, and auditing consideration for some transportation systems is infrastructure. See the discussion about infrastructure in chapter 7. Some transportation systems meet the criteria in GASB Statement No. 34 paragraph 67 requiring reporting as an enterprise fund (as discussed in chapter 2). If a transportation system does not meet those criteria, it may use either governmental fund or enterprise fund accounting and financial reporting. The auditor should apply the concept of opinion units in planning, performing, evaluating the results of, and reporting on audits of transportation systems, as discussed in paragraph 12.09.

12.37 Because of low rates or low ridership, many public transportation systems receive grants and appropriations from other governments to finance facilities, equipment, or operating expenses. Those grants and appropriations subject a system to various legal and contractual provisions that may affect its financial statements. For example, the U.S. Department of Transportation's Federal Transit Administration issues circulars that contain grant management guidelines for its various programs. The auditor should consider whether it is necessary to evaluate the system's compliance with those requirements as part of the financial statement audit. (See paragraph 12.10.) Further, as discussed in chapter 6, such grants and appropriations reported in enterprise funds generally should not be reported as operating revenue but, rather, as nonoperating revenue or as capital contributions, reported separately after nonoperating revenues and expenses.

Utilities

12.38 Electric, water, gas, sewer, and other utility operations often meet the criteria in GASB Statement No. 34 paragraph 67 requiring the use of enterprise funds (as discussed in chapter 2). If those criteria are not met, the utility may use either governmental fund or enterprise fund accounting and financial reporting. The auditor should apply the concept of opinion units in planning, performing, evaluating the results of, and reporting on audits of utilities, as discussed in paragraph 12.09. Utilities are subject to various regulatory, legal, and contractual provisions that may affect their financial statements. As discussed in paragraph 12.10, the auditor should consider whether it is necessary to evaluate the entity's compliance with those requirements as part of the financial statement audit and follow the guidance in AU-C section 250.

12.39 A governmental utility's services often are rate regulated, with those rates established by the utility's (or the government's) governing body. A government, meeting all of the criteria in GASB Statement No. 62 paragraph 476, may apply the provisions of GASB Statement No. 62 paragraphs 477–500, as amended, to activities reported in enterprise funds and as business-type activities that have regulated operations.[15] Unless there are conflicting

[15] Other governmental services not normally considered utility services, such as municipal solid waste landfills, also may be rate-regulated and may qualify to use the provisions of GASB Statement No. 62 paragraphs 476–487, as amended.

provisions, governments that apply the provisions of GASB Statement No. 62 paragraphs 477–500, as amended, should also apply other authoritative accounting pronouncements that are applicable to business-type activities. Therefore, governmental utilities should apply the financial statement formatting and note disclosure requirements of GASB Statement No. 34, as amended, GASB Statement No. 62, as amended, and other applicable GASB pronouncements for those financial statements to be in accordance with GAAP.[16] In auditing a public utility, the auditor should evaluate whether the utility's services are rate regulated and, if so, the entity's accounting policy with regard to applying the provisions of GASB Statement No. 62, as amended. (See the further discussion of the accounting for regulated operations in the section on user fees in chapter 6.)

Postemployment Benefit Plans

12.40 Governments establish plans in various ways to provide postemployment benefits. A common approach is to use a PERS. A PERS is a governmental entity that administers one or more defined benefit pension plans that is administered through a trust or equivalent arrangement that meets the specified criteria[17] and that also may administer other types of employee benefit plans, including postemployment benefit other than pensions (OPEB) plans and deferred compensation plans. GASB Statement No. 34 paragraph 140, as amended, requires a PERS that administers more than one defined benefit pension plan that is administered through a trust or equivalent arrangement that meets specified criteria or defined benefit OPEB plan that is administered through a trust or equivalent arrangement that meets the specified criteria to present combining financial statements for all plans of those types administered by the PERS and, if applicable, RSI for each plan. Paragraph 140, as amended, provides that a PERS should meet that requirement either by (*a*) presenting a separate column for each plan administered on the statements of fiduciary net position and changes in fiduciary net position or (*b*) presenting combining financial statements for those plans as part of the basic financial statements. GASB Statement No. 34 paragraph 141, as amended, encourages but does not require a PERS to present combining financial statements for types of plans that it administers other than defined benefit pension or OPEB plans that are administered through a trust or equivalent arrangement that meets the specified criteria.

12.41 When pension plans and OPEB plans that are administered through trusts or equivalent arrangements that meet specified criteria are included in a primary government's financial statements, GASB Statement No. 34 paragraph 106, as amended, requires presentation of the financial statements for the individual plans in the notes to the financial statements if sepa-

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[16] For example, an electric utility may want to present line items in its statement of net position using aggregations and sequences that are inconsistent with some of the requirements of GASB Statement No. 34, as amended. To be in accordance with with generally accepted accounting principles (GAAP), the presentation in that statement should be consistent with these requirements, as amended, and other applicable GASB pronouncements.

[17] Pension plans that are administered through a trust or equivalent arrangement that meets the specified criteria may be defined contribution plans or defined benefit plans. Defined benefit pension plans may be single-employer plans, agent multiple-employer plans, or cost-sharing multiple-employer plans. Those different types of plans are discussed in chapter 8, "Expenses or Expenditures and Liabilities" (for pensions not administered through trusts or equivalent arrangements that meet the specified criteria), and chapter 13, "Defined Benefit Pension Plans (Plan & Employer Considerations)" (for pensions and pension plans administered through trusts meeting specified criteria).

rate GAAP financial reports have not been issued. If separate GAAP financial reports have been issued, the notes should include information about how to obtain those separate reports (see chapter 13, "Defined Benefit Pension Plans (Plan & Employer Considerations)," and chapter 14, "Defined Benefit Postemployment Benefits Other Than Pensions (Plan & Employer Considerations)," for further discussion). An unmodified auditor's opinion on a plan's separate report could provide evidence that the report is in accordance with GAAP. If a plan's separate report is not presented in accordance with GAAP, the primary government is not allowed to limit its disclosure of plan information to a reference to the separate report.

12.42 The auditor should apply the concept of opinion units in planning, performing, evaluating the results of, and reporting on audits of a PERS, as discussed in paragraph 12.09.

12.43 Although the audit objectives for state or local governmental pension plans are similar to those for private-sector pension plans, the Employee Retirement Income Security Act of 1974 (ERISA), which generally applies to private-sector pension plans, does not apply to most governmental entities (certain plans of Indian tribes, educational institutions, and component units may be subject to ERISA and Department of Labor audit and reporting requirements). Instead, state and local laws and regulations that govern the operations of a pension plan may affect, for example, allowable investments, investment income allocation, funding requirements, participant eligibility and vesting, and payments to plan members and beneficiaries. As discussed in paragraph 12.10, the auditor should consider whether it is necessary to evaluate the entity's compliance with legal and contractual provisions as part of the financial statement audit and follow the guidance in AU-C section 250.

Pension Plans

12.44 GASB Statement No. 67, *Financial Reporting for Pension Plans—an amendment of GASB Statement No. 25*, as amended, applies to pension plans that are administered through trust or equivalent arrangements that have the following characteristics:

- Contributions from employers and nonemployer contributing entities to the pension plan and earnings on those contributions are irrevocable.
- Pension plan assets are dedicated to providing pensions to plan members in accordance with the benefit terms.
- Pension plan assets are legally protected from the creditors of employers, nonemployer contributing entities, and the pension plan administrator. If the plan is a defined benefit pension plan, plan assets also are legally protected from creditors of the plan members.

GASB Statement No. 73, *Accounting and Financial Reporting for Pensions and Related Assets That Are Not Within the Scope of GASB Statement 68, and Amendments to Certain Provisions of GASB Statements 67 and 68*, provides guidance for pensions provided through plans that are not administered through trusts or equivalent arrangements that meet the specified criteria and amends GASB Statement No. 67 and No. 68, *Accounting and Financial Reporting for Pensions*. Guidance related to pension plans is provided in chapter 13.

OPEB Plans

12.45 GASB Statement No. 74, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, establishes accounting and financial reporting standards for plans that provide OPEB. GASB Statement No. 74 is applicable to OPEB plans that are administered through trusts that meet specified criteria, and financial reporting for assets accumulated for purposes of providing defined benefit OPEB through OPEB plans that are not administered through trusts that meet the specified criteria. Guidance related to OPEB plans is provided in chapter 14.

Public Entity Risk Pools

12.46 A *public entity risk pool* is a cooperative group of governmental entities joining together to finance an exposure, liability, or risk relating to, for example, property and liability, workers' compensation, or employee health care claims. A pool may be a stand-alone entity or a component unit of or a part of a governmental entity that acts as the pool's sponsor. All public entity risk pools should account for their activities in an enterprise fund regardless of whether there is a transfer or pooling of risk (and regardless of whether the criteria in GASB Statement No. 34 paragraph 67 requiring the use of enterprise funds is met). The auditor should apply the concept of opinion units in planning, performing, evaluating the results of, and reporting on audits of public entity risk pools, as discussed in paragraph 12.09. Public entity risk pools are subject to various legal and contractual provisions that may affect their financial statements. As discussed in paragraph 12.10, the auditor should consider whether it is necessary to evaluate the entity's compliance with those requirements as part of the financial statement audit and follow the guidance in AU-C section 250.

12.47 The principal GASB pronouncements relating to the accounting and financial reporting for public entity risk pools are GASB Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, as amended, and No. 30, *Risk Financing Omnibus—an amendment of GASB Statement No. 10*, as amended, and GASB Interpretation No. 4, *Accounting and Financial Reporting for Capitalization Contributions to Public Entity Risk Pools—an interpretation of GASB Statements No. 10 and 14*. Paragraph 7 of the GASB IG 2015-1 provides additional guidance. In addition, GASB IG 2015-1 question 7.73.3 discusses how interest earnings on a public entity risk pool's investments generally should be classified as nonoperating revenue.

12.48 As discussed in chapter 1, although governmental entities are not within the scope of the AICPA Audit and Accounting Guide *Property and Liability Insurance Entities*, that guide may provide auditing procedures useful to the audits of public entity risk pools. This guide, however, contains information about governmental accounting and financial reporting standards and other matters that are unique to or prevalent in government and not included in *Property and Liability Insurance Entities*. Those matters are discussed throughout this guide, but the most potentially relevant matters for the financial statements of legally separate public entity risk pools are discussed in the section of this chapter titled "Financial Reporting Requirements for Special-Purpose Governments," the "Auditing Considerations" sections of other chapters, chapters 4, 15–17, and appendix B.

12.49 GASB Statement No. 10 paragraphs 18–50 as amended and interpreted, provide accounting and financial reporting guidance for public entity risk pools in which there is some transfer or pooling (sharing) of risk. Those standards concern the recognition of various revenues and costs (such as premium revenues, claims costs, policy or participation contract acquisition costs, and policyholder dividends), the valuation of investments (see chapter 5, "Investments, Certain Equity Interests, and Derivatives"), and certain specific disclosures. GASB Statement No. 10, as amended, requires certain revenue and claims development information to be included as RSI immediately after the notes to financial statements in separate pool financial reports. Pools included as part of a reporting entity and that do not issue separate financial reports should present the RSI after the notes to the reporting entity's financial statements. However, if the reporting entity issues a comprehensive annual financial report, GASB Statement No. 30 paragraph 7 permits those pools to present the RSI in the statistical section. However, the placement of that information in the statistical section does not change its character as RSI, or the nature of the limited procedures or the auditor's reporting on it. (Chapters 4 and 16 discuss the auditor's responsibility for and reporting on RSI.)

12.50 GASB Statement No. 10 paragraph 51 provides that public entity risk pools that do not transfer or pool risk among participants are acting as claims servicers and not insurers. The activity statements of these pools should report claims servicing revenue and administrative costs. Amounts collected or due from pool participants and paid to settle claims should be reported as a net asset or liability on an accrual basis.

External Investment Pools

12.51 An external investment pool is an arrangement that commingles (pools) the moneys of more than one legally separate entity and invests, on the participants' behalf, in an investment portfolio wherein one or more of the participants is not part of the sponsor's reporting entity. External investment pools sponsored by individual state or local governments or jointly by more than one government are known as *governmental external investment pools*.

12.52 The principal GASB pronouncements relating to the accounting and financial reporting for governmental external investment pools are GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, as amended, and GASB Statement No. 79, *Certain External Investment Pools and Pool Participants*. Paragraph 11 of the GASB IG 2015-1 provides additional guidance.

12.53 The manner in which governmental external investment pools value their investments depends on whether the pool meets the criteria of GASB Statement No. 79. Governmental external investment pools, other than qualifying external investment pools, generally report investments at fair value. A qualifying external investment pool may elect to measure all of its investments at amortized cost if it meets the following criteria: (*a*) the pool transacts with its participants at a stable net asset value per share, (*b*) if the portfolio meets certain maturity, quality, diversification, liquidity, and shadow pricing requirements. An external investment pool that is significantly noncompliant with any of the criteria in paragraph 4 of GASB Statement No. 79 during the reporting period general should not measure all of its investments at amortized cost, provided that the fair value of those investments is not significantly affected by the impairment of the credit standing of the issuer or by other factors. GASB Statement No. 31, as amended, and GASB Statement No. 72 provide guidance for valuing particular types of investments at fair value and for measuring investment income. Chapter 5 of this guide describes that guidance and discusses related auditing considerations.

12.54 GASB Statement No. 31 paragraph 17 states that separate or standalone annual financial reports for governmental external investment pools should include a statement of net position and a statement of changes in net position prepared on the economic resources measurement focus and the accrual basis of accounting. All investment income, including changes in the fair value of investments, should be reported in the statement of changes in net position. GASB Statement No. 31 paragraph 13, as amended, provides that when the change in the fair value of investments is identified separately as an element of investment income, it should be captioned "net increase (decrease) in the fair value of investments." If the investment is an asset recognized pursuant to an irrevocable split-interest agreement, the change in fair value should be recognized as an increase or a decrease in the related liability or deferred inflow of resources based on the application of the provisions of GASB Statement No. 81, *Irrevocable Split- Interest Agreements*. See paragraphs 12.82–.83 related to split-interest agreements.

12.55 GASB Statement No. 31 paragraph 17, as amended, provides certain disclosure requirements for the separate financial reports of governmental external investment pools, in addition to those required by other GASB standards as discussed in other chapters of this guide.

12.56 GASB Statement No. 31 paragraph 18, as amended by GASB Statement No. 34 and No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*, requires governments that sponsor one or more external investment pools (sponsoring governments) to report the external portion[18] of each pool as a separate investment trust fund, presenting statements of fiduciary net position and changes in fiduciary net position for each investment trust fund and captioning the difference between the external pool assets, deferred outflows of resources, liabilities, and deferred inflows of resources as net position amounts held in trust for pool participants. This requirement for reporting each pool as a separate fund applies to the sponsoring government's combining and individual fund financial statements, which are not part of the government's basic financial statements. Rather, combining and individual fund financial statements are presented as "GASB defined" SI. (Chapters 4 and 16 discuss the auditor's responsibility for and reporting on OI and SI under AU-C sections 720 and 725, respectively.)

12.57 If an external investment pool issues a separate report, GASB Statement No. 31 paragraph 19, as amended, requires the sponsoring government to describe in the notes to the financial statements how to obtain that report. If an external investment pool does not issue such a report, the sponsoring government's notes to the financial statements should include certain disclosures, including, for example, condensed statements of net position and changes in net position for each pool. The presumption in this disclosure requirement is that the separate pool report is in accordance with GAAP. An unmodified auditor's opinion on the pool's separate report could provide evidence of conformity with that requirement. If a pool's separate report is not presented in accordance with

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[18] The external portion of an external investment pool is the portion that belongs to legally separate entities that are not part of the sponsoring government's financial reporting entity. The internal portion of each external investment pool is the portion that belongs to the primary government and its component units and should be reported as assets in those funds and component units.

GAAP, the sponsoring government does not qualify to limit its disclosure of pool information to a reference to the separate report.

12.58 Other chapters of this guide, in particular chapter 5, discuss accounting and financial reporting standards that affect governmental external investment pools as well as audit objectives, internal control features, and audit procedures that would be appropriate for audits of those pools. There are unique accounting and financial reporting requirements for such pools as well as the various compliance requirements that affect how they operate. Those compliance requirements may affect, for example, allowable investments, investment income allocation, and distributions and reporting to pool participants. (See paragraph 12.10 concerning the auditor's responsibility for compliance requirements in a financial statement audit.) The auditor should apply the concept of opinion units in planning, performing, evaluating the results of, and reporting on audits of governmental external investment pools, as discussed in paragraph 12.09. Further, the accounting and financial reporting guidance in the AICPA Audit and Accounting Guides *Brokers and Dealers in Securities*; *Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies, and Mortgage Companies*; *Special Considerations in Auditing Financial Instruments*; and *Investment Companies* does not constitute category B accounting and financial reporting guidance for governmental entities because the AICPA did not make those guides applicable to those entities and GASB did not clear any of the guidance therein. However, even though those guides are not applicable to governmental entities, auditors could consider referring to them for specific auditing considerations relating to external investment pools (such as, for example, audit procedures relating to cash and investments).

Colleges and Universities

12.59 Many colleges and universities are governmental entities. Some governmental (public) colleges and universities are part of the legal entity of a state or local government,[19] whereas others are primary governments, standalone governments, or component units of a primary government. (Chapter 3 discusses the definition of the financial reporting entity and financial reporting provisions of GASB Statement No. 14, as amended.) This section often uses the terms *public institutions* and *institutions* to refer to public colleges and universities. The auditor should apply the concept of opinion units in planning, performing, evaluating the results of, and reporting on audits of colleges and universities, as discussed in paragraph 12.09.

Financial Reporting Requirements

12.60 GASB Statement No. 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities—an amendment of GASB Statement No. 34*, requires that public institutions apply the accounting and financial reporting standards of GASB Statement No. 34. A public institution that is not a legally separate entity should be reported within the fund structure of the government of which it is a part. A public institution that is a legally separate entity should report as a special-purpose government (*a*) engaged only in business-type activities, (*b*) engaged only in governmental activities, or (*c*) engaged in both governmental and business-type activities, as

[19] Public college and universities that are part of the legal entity of a state or local government sometimes issue separate individual fund or departmental financial statements, as discussed in chapter 16.

discussed in paragraphs 12.04–.07. Each institution should determine which of the three presentations is most appropriate to its activities. A primary government or other entity with financial reporting oversight responsibilities may require a particular financial statement presentation for public institutions. The auditor should evaluate whether a mandated financial statement presentation is in accordance with GAAP for a particular institution. An institution's other accounting and financial reporting policies or processes also may be mandated by other entities. For example, a primary government may require that a component unit institution report the expenses in its enterprise fund statements of revenues, expenses, and changes in fund net position by function (for example, instruction, academic support, student services, and so forth), rather than by natural (object) classification (for example, salaries and wages, employee benefits, supplies, and utilities).

12.61 If a legally separate institution reports as engaged only in business-type activities, it should present its activities using the three financial statements required for enterprise funds: a statement of fund net position; a statement of revenues, expenses, and changes in fund net position; and a statement of cash flows.[20] An institution's presentation of more than one enterprise fund is governed by NCGA Statement 1 paragraph 30 as amended, which indicates that individual funds are not required for financial reporting purposes unless required by legal or contractual provisions or by GAAP. (Question 7.97.4 of the GASB IG 2015-1 discusses an institution's presentation of financial information in multiple columns.)

12.62 If a legally separate public institution is engaged only in governmental activities or engaged in both governmental and business-type activities, it should present both the government-wide financial statements and the applicable fund financial statements required by GASB Statement No. 34. (See the discussion of those financial statements in paragraphs 12.05–.06 and chapter 2.)

Internal Control and Compliance Requirements

12.63 Because of the unique characteristics of each public institution, it is not possible to suggest uniform or standard internal control. Further, internal control may not be the same across all units of a multi-campus or multi-institution system. Auditors should obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements whether due to fraud or error, and to design the nature, timing, and extent of further audit procedures.

12.64 Public institutions usually are subject to various legal and contractual provisions that may affect their financial statements. For example, besides the financial reporting requirements discussed in paragraph 12.63, there may

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[20] Although not required, GASB Statement No. 34 paragraph 123 encourages entities that report as engaged only in business-type activities also to present as SI other than RSI (referred to in this guide as "*GASB defined*" *SI*) a statement of activities (which is the government-wide activity statement as discussed in chapter 2). It also encourages entities to present such a statement of activities as "GASB defined" SI for multiple-function enterprise funds if they want to present disaggregated data beyond what is required for segment reporting. (Chapter 4, "General Auditing Considerations," and chapter 16 discuss the auditor's responsibility for and reporting on other information (OI) and SI under AU-C sections 720, *Other Information in Documents Containing Audited Financial Statements*, and 725, *Supplementary Information in Relation to the Financial Statements as a Whole* [AICPA, *Professional Standards*], respectively.)

be compliance requirements relating to grants, appropriations from other governments, contributions, endowments, split-interest agreements, and debt issuances. As discussed in paragraph 12.10, the auditor should consider whether it is necessary to evaluate the institution's compliance with those requirements as part of the financial statement audit and follow the guidance in AU-C section 250.

Governmental and Private-Sector Not-for-Profit Accounting and Financial Reporting Differences

12.65 There are various differences between the accounting and financial reporting standards for public institutions and those for not-for-profit institutions, many of which are highlighted in the following list. (This listing is provided to help auditors experienced with not-for-profit institutions. Auditors who are unfamiliar with private-sector not-for-profit standards [not-for-profit standards] do not need to understand those standards to understand the standards for public institutions.) Auditors should become familiar with governmental standards for public institutions as discussed in this section and elsewhere in this guide when performing audits for those entities:

- *Order of presentation of assets and liabilities.* Governmental standards require the enterprise fund statement of net position to present assets and liabilities as current or long-term and the government-wide statement of net position to present assets and liabilities based on liquidity or use current and long-term classifications. (See chapter 2.) Not-for-profit standards require not-for-profit institutions to provide information about liquidity or maturity of assets and liabilities either in the statement of financial position or in the notes to the financial statements.
- *Deferred inflows of resources and deferred outflows of resources.* Governmental standards have two elements (deferred inflows of resources and deferred outflows of resources) that are not present in not-for-profit standards.
- *Accounting and financial reporting for specific types of transactions.* Governmental standards for certain types of transactions, such as investments, nonexchange transactions, pensions, and OPEB (see chapters 5–6, 8, and 13), differ from not-for-profit standards.
- *Pell grants.* Under governmental standards, public institutions consider Pell grants to be pass-through grants and report the federal funds as nonoperating[21] revenues (see paragraph 12.68). The FASB *Accounting Standards Codification* glossary defines an *agency transaction* as "a type of exchange transaction in which the reporting organization acts as an agent, trustee, or intermediary for another party that may be a donor or donee." Because they are acting as an intermediary for the student receiving the grant, not-for-profit institutions treat Pell grants as agency transactions and do not report the federal funds as contribution revenue to the institution.
- *Promises to give (pledges).* Not-for-profit standards require the discounting of unconditional promises to give that are to be received

[21] GASB IG 2015-1 question 7.72.10.

over an extended period. Governmental standards neither require nor prohibit discounting. (See chapter 6.) Not-for-profit standards also require that endowment pledges be recognized in the period that they are made. When there are no eligibility requirements, governmental standards do not allow recognition until payments have been made on these pledges.

- *Contributions made to other organizations.* Donors sometimes make contributions to one organization for the benefit of another organization. Not-for-profit standards require an institution that is the ultimate beneficiary of such a contribution to recognize the beneficial interest (contribution and the asset held by the recipient organization) under certain circumstances. Governmental standards also provide for the recognition of a beneficial interest and a deferred inflow of resources for contributions received by another organization under a split-interest agreement (see paragraph 12.83). Governmental standards may require the presentation as a component unit of a legally separate, tax-exempt organization that receives or holds economic resources entirely or almost entirely for the direct benefit of the primary government, its component units, or its constituents. (See the further discussion in paragraph 12.88.)
- *Use of restricted component of net position.* Not-for-profit standards require that when an expense is made for a purpose for which both unrestricted and temporarily restricted net position exists, the expense should be charged to restricted net position unless the expense is directly attributable to another specific external revenue source. Governmental standards require that restricted net position be reported until the resources are used for the specified purpose. Even though governmental standards do not impose a "flow assumption" for purposes of expense recognition, a public institution's management should establish a policy concerning whether to first apply specific expenses to unrestricted or restricted resources because governmental standards require disclosure of that policy. (See the additional discussion of this provision of governmental standards in chapter 8.)
- *The financial reporting of equity.* Governmental standards establish the following three components of net position for presentation in government-wide and enterprise fund financial statements: (*a*) net investment in capital assets, (*b*) restricted, and (*c*) unrestricted. Not-for-profit standards establish the following three classes of net assets: (*a*) permanently restricted, (*b*) temporarily restricted, and (*c*) unrestricted. Governmental standards require that restricted net position be displayed separately for expendable and nonexpendable restricted net position and that the purpose of restricted net position be displayed to some extent. Not-for-profit standards permit display of the purpose of temporarily restricted net assets but alternatively permits those purposes to be disclosed in the notes to the financial statements. Governmental standards prohibit display of management designations of unrestricted net position on the face of the government-wide and enterprise fund financial statements but do not prohibit disclosure in the notes. Not-for-profit standards permit information about

designations to be provided in notes to or on the face of the financial statements. (See the further discussion of the display and disclosure of equity in chapter 10, "Net Position and Financial Statement Reconciliations.")

- *Cash flow statements.* Governmental standards require that cash flow statements for enterprise funds be prepared using the direct method. Not-for-profit standards permit either the direct or indirect method. With the use of the direct method, governmental standards require a reconciliation from operating income to net cash flow from operating activities, whereas not-for-profit standards require the reconciliation to be from the change in net assets. Governmental standards specify four categories for reporting cash flows (see chapter 2), whereas standards for not-for-profit institutions specify three categories. Although two of the categories (operating and investing) are named the same in governmental and not-for-profit standards, and governmental standards have two financing categories whereas not-for-profit standards only have one financing category, the cash flows reported within each category differ in several significant ways between governmental and not-for-profit standards.
- *Note disclosures.* Governmental standards require specific information in note disclosures that are not required by standards applicable to not-for-profit institutions, such as for cash and investments (see chapter 5), capital assets (see chapter 7), and long-term debt and segments (see chapter 8). Similarly, standards applicable to not-for-profit institutions require specific information in note disclosures that are not required by governmental standards such as certain information about endowments.
- *Required supplementary information*. Governmental standards require the presentation of an MD&A and other applicable RSI. (Chapter 2 discusses GASB's RSI requirements and chapters 4 and 16 discuss the auditor's responsibility for and reporting on RSI.) There are no RSI requirements for not-for-profit entities.

Tuition and Fees

12.66 GASB IG 2015-1 question 7.72.13 provides that revenues from tuition and student fees of an academic term that encompass two fiscal years—for example, a summer session—should be recognized partly in each year by accruing the amount earned each year.

Scholarship Discounts and Allowances

12.67 GASB Statement No. 34 footnote 41 requires proprietary funds (which include enterprise funds) to report revenues net of discounts and allowances with the discount or allowance amount parenthetically disclosed on the face of the statement of revenues, expenses, and changes in fund net position or in a note to the financial statements. Alternatively, revenues may be reported gross with the related discounts and allowances reported directly beneath the revenue amount. That requirement applies to scholarship discounts and allowances that satisfy a student's tuition and fees, housing, meals, books, and other goods and services provided by the institution. For such discounts and allowances reported for governmental activities in the government-wide statement of activities, question 7.40.3 of the GASB IG 2015-1 states that the same reporting requirements should be applied.

Pell Grants

12.68 Pell grants (Catalog of Federal Domestic Assistance program number 84.063) is an entitlement program funded by the federal government that is a major source of aid to college and university students. Institutions have administrative and direct financial involvement with Pell grants because they determine eligible secondary recipients (such as determining that students are enrolled in eligible programs and in the number of credit hours required for the level of awards) and are liable for disallowed costs. Therefore, under the provisions of GASB Statement No. 24, *Accounting and Financial Reporting for Certain Grants and Other Financial Assistance*, paragraph 5, institutions should report Pell grants as nonoperating revenues. (Question 7.72.10 of the GASB IG 2015-1 discusses the reporting of Pell grants.)

Enterprise Fund Revenue and Cash-Flow Classifications

12.69 Paragraphs 12.59–.62 discuss how institutions should classify certain resource inflows (*a*) as operating revenues, nonoperating revenues, or capital contributions in the enterprise fund statement of revenues, expenses, and changes in fund net position and (*b*) as cash flows from operating, noncapital financing, capital and related financing, or investing activities in the enterprise fund statement of cash flows. Chapter 6 discusses the standards for revenue classifications and disclosures in GASB Statement No. 34, as amended, including how defining a proprietary fund's operating revenues and expenses should consider how individual transactions would be categorized for purposes of preparing a statement of cash flows. Chapter 2 discusses the requirements of GASB Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*, as amended.

Research Grants and Contracts

12.70 Public institutions receive funding from various sources—the federal government, state and local governments, businesses, and individuals—for various purposes. As stated in GASB IG 2015-1 question 7.73.1, revenues for which cash flows are reported as from operating activities likely also would be regarded as operating revenues. GASB Statement No. 9 paragraph 17c provides that cash flows from operating activities include cash receipts from grants for specific activities that are considered to be operating activities of the grantor government, stating that a grant arrangement of this type is essentially the same as a contract for services. Therefore, revenue from research grants and contracts that meet the criterion for reporting as cash flows from operating activities also generally should be reported as operating revenue. The auditor should understand the predominant characteristics and substance of research grants and contracts to evaluate how management has classified those amounts in the statement of cash flows and the statement of revenues, expenses, and changes in fund net position.

State and Local Government Appropriations

12.71 Many public institutions receive appropriations from state or local governments. As provided in chapter 6, nonoperating revenues generally should include revenues from appropriations between primary governments and their component units for operating purposes or that may be used, at the recipient's discretion, for either operating purposes or capital outlay.[22] Question 7.73.4 of the GASB IG 2015-1 indicates that institutions cannot establish a policy to include state appropriations in operating revenues. The illustrative statement of cash flows in the nonauthoritative appendix D of GASB Statement No. 35 illustrates cash flows from appropriations as cash flows from noncapital financing activities and capital and related financing activities.

Federal Land Grant Income

12.72 In the past, the federal government provided land to certain institutions, including land grant institutions, to be used to generate funds for the institutions in perpetuity. Those assets provide support to the institutions through the investment of moneys from the sale of the land or income produced by the land through mineral or other rights. Those assets would be endowments[23] if held by the institutions, but they usually are administered by a state land office or other governmental agency. There often are state statutes or other externally imposed restrictions on an institution's use of the income from those grants. The source of the revenues and any externally imposed restrictions on their use should be considered in determining the proper revenue classification in enterprise funds.

Third-Party Student Loans

12.73 Many students or their parents secure loans from a source other than the institution to assist with the cost of attending the institution. These are transactions between the students or parents and the lender, for example, a financial institution, the U.S. Department of Education, or a state loan program. Institutions receive funds from the lenders and then disburse funds to students or apply amounts to the students' accounts. These third-party transactions are not within the scope of GASB Statement No. 24, as amended, because they are not pass-through grants. There is no governmental standard that requires institutions to report the loan amounts received and disbursed as revenue. Institutions that report as engaged only in business-type activities and that have an accounting policy to report undisbursed loans at year-end as assets and liabilities in an enterprise fund statement of fund net position should report the cash flows for these third-party student loans in the enterprise fund statement of cash flows. GASB has provided no guidance concerning the appropriate category for reporting those cash flows. Some believe that reporting them as cash flows from noncapital financing activities is appropriate because the cash flows do not represent operating activities. Others note that cash flows from third-party loans are not listed in GASB standards as cash flows from capital and related financing, noncapital financing, or investing activities. They therefore believe that these cash flows should be reported as from operating activities based on GASB Statement No. 9 paragraph 17e, which specifies this category should include "all other cash receipts that do not result from transactions defined as capital and related financing, noncapital financing, or investing activities."

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[22] Questions 7.72.8 and 7.73.2 of the GASB IG 2015-1 support this classification requirement. Those questions also indicate that revenues that are restricted for the acquisition or construction of capital assets should be classified as capital contributions, reported separately after nonoperating revenues and expenses, not as nonoperating revenues.

[23] The provisions of GASB Statement No. 52, *Land and Other Real Estate Held as Investments by Endowments*, may be applicable depending on the facts and circumstances. See chapter 5, "Financial Instruments," of this guide for additional discussion of GASB Statement No. 52, as amended.

Institutional Student Loans

12.74 As opposed to third-party student loans discussed in paragraph 12.73, institutions often make student loans from institutional funds and earn interest income from making those loans. Guidance related to classifying that interest income as operating or nonoperating revenue in the enterprise fund statement of revenues, expenses, and changes in fund net position can be derived from GASB Statement No. 9 paragraph 19, which addresses classification for cash-flow purposes. Student loans from an institution's funds are not intended to be investments, but are undertaken, instead, to fulfill a governmental responsibility. Because such "program loans" are made and collected as part of a governmental program and are part of the operating activities of the governmental enterprise, the related cash flows should be classified as operating activities. (The illustrative statement of cash flows in the nonauthoritative appendix D of GASB Statement No. 35 illustrates this classification.) Similarly, interest income on the loans should be reported as operating revenue. (The principal amounts of the loans made and collected are reported as balance-sheet transactions and do not affect the enterprise fund statement of revenues, expenses, and changes in fund net position.)

Investment Income on Endowment Resources[24]

12.75 GASB Statement No. 9 requires cash inflows from investing activities (other than "program loans" as discussed in paragraph 12.74) to be classified in a category separate from cash flows from operating activities. Thus, investment income on endowment resources generally should be classified as nonoperating revenues in the enterprise fund statement of revenues, expenses, and changes in fund net position.[25] GASB Statement No. 31, as amended, permits the change in fair value of investments to be presented separately or combined with other investment income as a single amount. GASB Statement No. 52, *Land and Other Real Estate Held as Investments by Endowments*, as amended, establishes standards that require endowments to report their land and other real estate held as investments at fair value and to make certain disclosures about those investments. See chapter 5 of this guide for more information on GASB Statement No. 52, as amended.

Government-Wide Revenue Classification

12.76 Often, a public institution that presents its financial statements using enterprise fund accounting and financial reporting standards also will present or be presented in the government-wide statement of activities of the primary government. This would occur, for example, when a component unit institution is included in a reporting entity's financial statements. In the statement of activities, revenues that are not presented as contributions to term or permanent endowments, contributions to permanent fund principal, or special or extraordinary items are presented as either program revenues or general revenues. As discussed in GASB IG 2015-1 question 7.45.1, the distinction between operating and nonoperating revenues is not required to be made in the government-wide statement of activities. That question states that some

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[24] See the discussion of endowments starting in paragraph 12.77.

[25] GASB IG 2015-1 question 7.73.5 discusses how interest earnings on endowments generally should be classified as nonoperating revenue. In addition, question 7.74.3 states that it is not appropriate to report investment income restricted to increase permanent or term endowments as "additions to permanent or term endowments."

nonoperating revenues satisfy the criteria to be reported as program revenues, whereas some may be reported as general revenues. It further states that capital contributions (which are reported separately of operating and nonoperating revenues in the proprietary fund financial statements) often would be reported as program revenues. Question 7.37.3 of the GASB IG 2015-1 discusses the reporting of the change in fair value of investments as program or general revenues. When component unit public institutions do not present a government-wide statement of activities, their primary governments may require them to include government-wide revenue classification information in their basic financial statements so that audited information is available for the reporting entity's financial statements. Other governments will infer that information from the component unit financial statements as discussed in question 7.26.6 of the GASB IG 2015-1.

Endowments

12.77 Many public institutions have endowments, and the amounts may be large. The auditor should have an understanding of the legal and contractual provisions for endowments that could have a material effect on the financial statements, which may involve understanding the types of endowments, the applicable state law, how the institution manages the investment of the amounts, how the institution decides how much of the revenue to spend currently, and the proper financial reporting of both the earnings and net position. Institutions often define three types of endowments: permanent (or true) endowments, term endowments, and quasi-endowments. The following describes those three types of endowments and how their balances and activities are reported in enterprise funds. Paragraph 12.75 and footnote 25 discuss enterprise fund reporting of investment income on endowment resources:

- Permanent (or true) endowments are amounts for which donors or other outside entities have stipulated, as a condition of the gift instrument, that the principal is to be maintained in perpetuity. Terms of the gift instrument will stipulate how earnings on the endowment principal are to be used: either added to the endowment account, used for some specific restricted purpose, or used for unrestricted purposes. The net position of permanent endowments should be reported as restricted and nonexpendable. Net position resulting from earnings should be reported in a component of net position based on the stipulations in the gift instrument.[26]
- Term endowments are similar to permanent endowments except that, upon the passage of a stated period of time or the happening of a particular event, all or a part of the principal may be expended. Terms of the gift instrument will stipulate how earnings are to be used. The net position of term endowments should be reported as restricted and expendable (see GASB IG 2015-1 question 7.24.6). Net position resulting from earnings should be reported in a component of net position based on the stipulations in the gift instrument.
- Quasi-endowments (or funds functioning as endowments) are amounts that the institution's governing board, rather than a

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[26] GASB IG 2015-1 question 7.24.27 indicates that earnings on a donor-restricted endowment that the entity (university) voluntarily reinvests into the endowment with the same restrictions as previous principal amounts also should be classified as (nonexpendable) restricted net position.

donor or other outside entity, has determined should be managed as if they were a permanent or term endowment. (Those amounts may have come from unrestricted resources or from moneys that a donor or other outside entity restricted for use for a particular purpose.) Net position should be reported as if the board had not designated the amounts as quasi-endowments. Thus, net position should be reported as restricted and expendable or as unrestricted, depending on whether there are restrictions on the resources used to create the quasi-endowment.

12.78 A major issue concerning permanent and term endowments is whether the endowments are governed by trust law. The most significant consequence of the resulting conclusion is whether realized and unrealized appreciation on investments should be considered to increase the endowment balance or whether all or part of the appreciation may be expended the same as income. *Income* includes dividends, interest, rents, royalties, and the like but not gains from appreciation. The traditional legal view is that endowments are subject to treatment as trusts. Under classical trust doctrines, gains on endowment funds can be added only to principal and cannot be expended.

12.79 Most institutions today do not consider endowment funds to be governed by trust law. Advocates of this legal view hold that the trust law is inapplicable to endowment funds and that the concepts of corporate law are more applicable if the issues involved are administrative in nature, such as endowment investment management and allocation of gains to income or principal. The corporate law concept views the institution as the absolute owner of gifts with the obligation to include gains as income. Under the corporate law concept, the income beneficiary and remainderman are usually the same, whereas trust law demands a fair division between the income beneficiary and the remainderman (which are two distinct and sometimes antagonistic interests). Under trust law, gains traditionally have been kept for the remainderman. Support for not following trust law is found in the Uniform Prudent Management of Institutional Funds Act (enacted by 49 states as of the date of this guide) and in the Uniform Management of Institutional Funds Act. Those laws contain a standard of prudence and the governing board usually is required to determine how it will allocate earnings to spending and to maintaining the earning power of an endowment amount.

12.80 Most institutions have adopted what is usually referred to as a *total return* approach to endowment fund investment management. That approach emphasizes total investment return: traditional yield plus or minus gains and losses. Practically all total return approaches emphasize the use of prudence and a rational and systematic formula in determining the portion of gains that may be spent and call for the protection of endowment principal from the loss of purchasing power (inflation) as a primary consideration before spending gains. Total return approaches have many variations, including some provisions to eliminate extreme short-term fluctuations in the amounts that are allocated for spending. The total return approach does not change how earnings are reported. GASB standards neither require nor prohibit reporting earnings in more detail (for example, distinguishing between nonendowment and endowment investment income) either on the face of the statement of revenues, expenses, and changes in fund net position or by note disclosure.

12.81 Paragraph 121 of GASB Statement No. 34, as amended, requires note disclosure of certain information about donor-restricted endowments, including the state law regarding the ability to spend net appreciation and the spending policy. The spending policy or *spending rate* is the amount of the total return that the institution will make available for spending. State laws vary, even when based on a uniform act, and under many state laws, the trustees are required to exercise prudence in setting the spending rate. GASB is silent on the spending rate other than requiring its disclosure.

Split-Interest Agreements

12.82 Public institutions often have split-interest agreements, which were at one time called annuity or life income agreements. Split-interest agreements include charitable gift annuity contracts, pooled life income trusts, charitable remainder unitrusts, charitable remainder annuity trusts, and charitable lead annuity trusts.[27] These agreements require careful attention to legal and tax issues. Individual agreements may contain specific provisions on permissible investments, permissible use of funds when the split-interest ends, or other matters. Often, some investments may be pooled with those of endowment accounts. However, in other cases, the provisions of agreements or the inherent objective of the investments dictate separate investments. In enterprise funds, earnings on the investment of these assets should be reported as nonoperating revenues. Determining the proper liability of these agreements is important. In enterprise funds, net position usually should be reported as restricted and as expendable or nonexpendable based on the conditions attached to the agreement on how the institution can use the funds when the split-interest terminates.

12.83 Guidance related to revocable split-interest agreements, in which a donor has reserved or conferred to another person the right to terminate the agreement at will and have the donated assets returned, and governmental benefits that are conditional upon an action or the occurrence of an event, is found in GASB Statement No. 33. Guidance related to irrevocable split-interest agreements that confer an unconditional beneficial interest is found in GASB Statement No. 81.

Expense Classifications

12.84 Questions 7.72.4–7.72.5 of the GASB IG 2015-1 explain that expense classification in the proprietary funds statement of revenues, expenses, and changes in fund net position may be by natural (object) classification or by function. If an institution presents its enterprise fund statement of revenues, expenses, and changes in fund net position using functional classifications, GASB standards neither require it to allocate nor prohibit it from allocating depreciation and operations and maintenance of plant expenses to each function, as discussed in GASB IG 2015-1 question 7.29.5.

12.85 GASB Statement No. 34, as amended by GASB Statement No. 37, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Omnibus—an amendment of GASB Statements*

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[27] These and other types of split-interest agreements are described in the AICPA Audit and Accounting Guide *Not-for-Profit Entities*. Note that the accounting and financial reporting guidance for those agreements in AICPA Audit and Accounting Guide *Not-for-Profit Entities* does not constitute category B guidance for governmental entities because the AICPA did not make that guide applicable to governmental entities and GASB did not clear the guidance therein. (See chapter 1 for a discussion of the GAAP hierarchy for governments.)

No. 21 and No. 34, requires the government-wide statement of activities to present activities accounted for in enterprise funds by *different identifiable activities*. (See the further discussion of that requirement in chapter 2.) GASB Statement No. 37 states that determining whether an activity is different may require the use of professional judgment but generally is based on the goods, services, or programs provided by an activity. It also states that for public institutions reported in enterprise funds, the variety of activities common to those institutions (such as food service, bookstore, residence halls, and student unions) generally would not be required to be reported separately because those various activities might be considered incidental to the delivery of a common product or service (higher education).

Fund-Raising Costs

12.86 Many public institutions solicit support through fund-raising activities conducted in conjunction with activities related to other functions, such as program activities or supporting services. AICPA Statement of Position (SOP) 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising* (AICPA, *Professional Standards*, ACC sec. 10), included as the supplement to this guide, establishes accounting and financial reporting standards for the costs of joint fund-raising and program activities.[28] It also requires disclosures about the nature of the activities for which joint costs have been allocated and the amounts of joint costs. Although that SOP applies to all governments, its provisions are only meaningful for entities that report using related functional classifications.

Segment Disclosures

12.87 GASB Statement No. 34, as amended by GASB Statement No. 37, requires governments that report enterprise funds or that use enterprise fund accounting and reporting standards to make certain segment disclosures in the notes to the financial statements relating to certain debt-financed activities. (See the further discussion of those requirements and the definition of segments in chapter 8.) GASB Statement No. 37, as amended, clarifies that a segment is an identifiable activity or a grouping of activities and, thus, reinforces the guidance in GASB IG 2015-1 question 7.86.2, which discusses how segment disclosures are made for a public university's revenue debt-financed residence halls. According to paragraph .A67 of AU-C section 501, *Audit Evidence—Specific Considerations for Selected Items* (AICPA, *Professional Standards*), the auditor's responsibility regarding the presentation and disclosure of segment information is in relation to the financial statements of the opinion unit(s) on which the segment information is based. Paragraph .25 of AU-C section 501 addresses the auditor requirements for segment information.

Component Units

12.88 In certain situations, public institutions may be required by GASB standards to include information about certain other legally separate organizations in their financial statements, often by presentation as component units. This may affect, for example, research foundations, fund-raising foundations,

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[28] Statement of Position 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising* (AICPA, *Professional Standards*, ACC sec. 10), includes portions that were cleared by GASB and thus are category B guidance for governmental entities. See the discussion of the governmental GAAP hierarchy in chapter 1.

and university hospitals (as well as their medical practice plans). See the discussion of GASB Statement No. 14, as amended, in chapter 3.[29]

Federal UBIT

12.89 Governmental colleges and universities and their wholly owned subsidiary corporations are subject to federal UBIT,[30] which is a tax on income derived from any trade or business that is regularly carried on and not substantially related to the organization's tax-exempt purpose or function. See the discussion of UBIT in chapter 8.

Specific Guidance for Indian Tribes

12.90 Federally recognized Indian tribes are sovereign entities, and the federal government considers them to be similar to state governments. Because they have the power to enact and enforce a tax levy and have the ability to issue debt that pays interest exempt from federal taxation directly (rather than through a state or municipal authority), federally recognized Indian tribes meet the definition of governmental organizations in chapter 1 of this guide, and they use governmental accounting and financial reporting guidance to prepare their financial statements. Under GASB standards, federally recognized Indian tribes usually are considered primary or stand-alone governments and, because they provide various services as would a general-purpose government, should present both government-wide and fund financial statements (see paragraph 12.05 and chapter 2). As with other governmental entities, the auditor should apply the concept of opinion units in planning, performing, evaluating the results of, and reporting on audits of federally recognized Indian tribes, as discussed in paragraph 12.09.

12.91 Indian tribes often operate housing programs, health care facilities, schools, colleges, and other activities for the benefit of their members. Specific guidance for some of these activities is provided in other sections of this chapter. Like state and local governmental entities, Indian tribes often receive substantial federal awards which are subject to federal audit requirements of Title 2 U.S. *Code of Federal Regulations* Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance), as applicable to the period under audit.

12.92 Tribes also often operate significant business activities in industries such as gaming, hospitality, recreation, real estate management and development, utilities, farming and ranching. In some cases, such business activities meet the criteria in paragraph 67 of GASB Statement No. 34 requiring the use of enterprise funds (as discussed in chapter 2). If those criteria are not met, the activities may be reported in either governmental or enterprise funds.

12.93 Certain citations of the accounting and financial reporting guidance in the AICPA Audit and Accounting Guide *Gaming* provide category B accounting and financial reporting guidance for gaming activities operated by tribes that use governmental accounting and financial reporting guidance to prepare

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[29] In particular, GASB Statement No. 39, *Determining Whether Certain Organizations Are Component Units—an amendment of GASB Statement No. 14*, amends GASB Statement No. 14, *The Financial Reporting Entity* to provide additional guidance to determine whether certain organizations for which the 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.

[30] See IRS Publication 598, *Tax on Unrelated Business Income of Exempt Organizations*.

their financial statements because GASB cleared those citations as applicable to governmental organizations. (See chapter 1 for a discussion of the GAAP hierarchy for governments.) Although other citations of that guide are not specifically made applicable to governmental entities by GASB, they provide specific accounting and auditing considerations relating to gaming activities. In addition, the auditor should obtain an understanding of the Indian tribe and the environment in which it operates, including federal and state laws and agreements, such as tribal-state gaming compacts, that govern the types of gaming and other activities that a tribe may conduct. As discussed in paragraph 12.10, the auditor should consider whether it is necessary to evaluate the tribe's compliance with those requirements as part of the financial statement audit.

Specific Guidance for State Governments

12.94 Generally, state governments are large operations, having assets and operations amounting to billions of dollars. The following discussion includes a number of accounting, financial reporting, and auditing considerations relating to state governments. Although some of those considerations also may affect local governments, they are more commonly associated with state governments.

Nature and Organization of State Governments

12.95 State governments are sovereign entities, with powers that are limited by their individual constitutions, the powers reserved exclusively for the federal government by the U.S. Constitution, and the rights guaranteed to citizens by amendments to the U.S. Constitution. Subject to those limitations, states can enact, repeal, and modify laws relating to the conduct of economic, political, social, and individual activities. All other governmental entities within a state exist as consequences of general or specific authorizations from the state government and are accorded only those powers provided for in such authorizations. State governments have implicit powers and subordinate governments created by states generally are limited to the powers expressly provided to them by the state or not expressly reserved for the state and, in some cases, not expressly prohibited.

12.96 To meet the varying needs of citizens, states have established various forms of state agencies and departments, regional governments, local governments, and special-purpose governments. The extent and nature of those organizations affect the structure of service delivery and the state financial reporting entity and, thus, the audit approach.

12.97 States usually operate on a highly decentralized basis. Given their numerous and varied activities, most states have established accountability centers under the control of an elected or high-level appointed official (usually a state comptroller or treasurer). In many cases, such centers' responsibilities are limited to appropriated funds. Consequently, such accountability centers normally do not maintain accountability for a state's component units or for certain large or autonomous agencies or departments (such as highway departments or state universities) that finance their operations primarily through user fees and purpose-restricted grants and contributions. In addition, in some states, the accountability centers do not maintain accountability for the operations of the offices of certain statewide elected officials or the state's legislative or judicial branches. When a state's centralized accountability center does not maintain accountability for certain component units, agencies, departments, or officials, those component units and other organizations maintain their own accounts and manage their own financial affairs, either with or without oversight from the accountability center.

12.98 Numerous accounting systems, with varied internal control, can exist within state governments and such systems may need to be evaluated for their effects, if any, on audit procedures. Auditors also should consider that there may be possible conflicts among the state officials with accounting responsibilities and consider whether the appropriate individuals are included in planning the audit, advised of audit progress, and provided opportunities to respond to draft reports.

Specialized Reporting Requirements

12.99 Accounting and reporting requirements for state governments may extend beyond GAAP. For example, state statutes may mandate certain additional financial summaries. Management should determine the existence and specifics of such requirements, including the need for auditor involvement, possibly through discussions with representatives of the offices of the state's attorney general, treasurer, comptroller, and auditor.

Reporting Entity Definition

12.100 Determining a state's financial reporting entity often is difficult because of the number, diversity, and autonomy of state component units, the existence of financially independent agencies and departments, and decentralized accounting systems. States also tend to be involved in more joint ventures than are local governments. Chapter 3 discusses the definition of the financial reporting entity and the related accounting and reporting under GASB Statement No. 14, as amended.

Separate Fund, Departmental, Agency, and Program Audits

12.101 Sometimes, separate audits of the GAAP-based financial statements of state funds, departments, agencies, and programs are performed, either as component elements of the audit of the state's financial statements or as completely separate efforts. Chapter 16 discusses those financial statements and illustrates auditor's reports for them.

Medicaid

12.102 Medicaid is a federal program that provides health care services to low-income persons. Medicaid services may be administered by states or through local governments on behalf of the states. In either case, health care providers (such as hospitals, physicians, nursing homes, and pharmacies), including governmental health care providers, are required to follow guidelines established by the state. Various methods and formulas are used to reimburse providers for services rendered, including the following:

- Hospitals and nursing homes may be reimbursed for the costs of rendering the services, with costs based on retrospective cost reports filed by the provider.
- Hospitals and other providers may be paid a predetermined (prospective) amount for each service rendered, based on the nature and complexity of the services.

- Nonhospital providers may be reimbursed based on the cost of the service (such as physician office visits and prescriptions) up to a maximum amount per service, or on a prospectively set rate that is based on the complexity of the type of service.

Some states make progress payments to providers, particularly hospitals, based on interim reports. Settlements may be made after the state's year-end, based on audited cost reports. Those settlements can result in either receivables from or payables to the providers.

12.103 The costs of Medicaid services are shared between the federal and state governments. In some states, local governments also share in the costs. Such sharing can vary by state and by the type of service rendered. The auditor may need to become familiar with the types of services provided and the cost-sharing arrangements and to evaluate whether the federal and state (and local, if applicable) shares have been properly allocated and thereby properly reported in the financial statements. The auditor also should consider whether it is necessary to evaluate the state's compliance with other Medicaid requirements as part of the financial statement audit. (See paragraph 12.10.)

12.104 Governments that administer the Medicaid program should recognize revenue and expenses and expenditures using the provisions of GASB Statement No. 33, as amended, as discussed in chapters 6 and 8. In many cases, Medicaid service providers may submit claims for payments well after year-end for services rendered before year-end. Such amounts are known as incurred but not reported (IBNR) amounts. The state may have to estimate the year-end IBNR amount payable to, or receivable from, providers. The state may estimate those IBNR amounts, for example, based on historical actual results that establish a reliable pattern, adjusted for known changes that affect that amount (such as increases in the reimbursement rate for particular services). If material, or a significant risk area, the auditor should evaluate the relevant assertions and might consider whether such payables and receivables (and related expenses, expenditures, and revenues) are properly estimated and recorded at year-end, including whether revenue recognition in governmental funds considers "availability."

Food Stamps

12.105 Food stamps, also now known as the Supplemental Nutrition Assistance Program (SNAP), is a federal program that permits low-income persons to buy nutritious food and certain necessary household items. GASB Statement No. 24, as amended,[31] provides guidance for how states should report food stamp transactions in the fund financial statements, requiring that they recognize distributions of food stamp benefits as revenue and expenditures in the general fund or a special revenue fund, whether the state distributes the benefits directly or through agents. Expenditures should be recognized when the benefits are distributed to the individual recipients by the state or its agents;[32] revenue should be recognized at the same time. States should report food stamp balances held by them or by their agents at the date of the financial statements

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[31] GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, as amended, does not apply to food stamps.

[32] GASB Statement No. 24, *Accounting and Financial Reporting for Certain Grants and Other Financial Assistance*, as amended, states that in an electronic benefit transfer system, distribution takes place when the individual recipients *use* the benefits

as an asset offset by a liability. Revenue, expenditures, and balances of food stamps should be measured based on face value. In the government-wide financial statements, food stamp-related balances and transactions should be measured using the economic resources measurement focus and the accrual basis of accounting. Physical controls over debit cards could be considered by the auditor when assessing the risk of material misstatement. The auditor might consider evaluating whether food stamps balances and transactions are properly reported in the financial statements. The auditor also should consider whether it is necessary to evaluate the state's compliance with the federal government's program requirements as part of the financial statement audit. (See paragraph 12.10.)

Unemployment Compensation Benefit Plans

12.106 Unemployment compensation is a federal-state partnership program providing payments to eligible unemployed workers that is funded principally by "experience-rated" federal and state taxes on employers. GASB Statement No. 34 requires unemployment compensation benefit plans to be reported as enterprise funds because the employer taxes are considered exchange-like or insurance transactions. NCGA Interpretation 9, *Certain Fund Classifications and Balance Sheet Accounts*, as amended, provides that the administrative costs related to a state's unemployment compensation program should be included in the general fund unless legal provisions require them to be reported in another fund. GASB IG 2015-1 question 7.50.8 states that such administrative activity should not be reported in the unemployment compensation enterprise fund. One significant accounting and financial reporting consideration relating to unemployment compensation plans may concern the calculation of the benefit liability and disclosure of additional contingencies. (Chapter 8 discusses the accounting, financial reporting, and auditing for contingent liabilities.) The auditor also should consider whether it is necessary to evaluate the state's compliance with the federal government's program requirements as part of the financial statement audit. (See paragraph 12.10.)

Lotteries

12.107 Most states conduct lotteries individually or through a multistate arrangement. Lottery activities may be (*a*) part of the state's legal entity[33] or (*b*) a legally separate entity that may be a component unit of the state. Lottery activities generally meet the criteria in GASB Statement No. 34 paragraph 67 requiring the use of enterprise funds (as discussed in chapter 2). If those criteria are not met, the lottery activity may use either governmental fund or enterprise fund accounting and financial reporting. The auditor might consider whether the financial statement amounts for lottery activities are properly measured and reported. The auditor also should consider whether it is necessary to evaluate the state's compliance with legal and contractual provisions that affect the financial statements, such as legal provisions relating to the use of lottery revenues. (See paragraph 12.10.) Although a legally separate state lottery qualifies as a component unit, it does not meet the criteria for blending described in paragraph 53b of GASB Statement No. 14, as amended. GASB IG 2015-1 question 4.32.5 explains that state lotteries are created primarily to generate revenue for the state, and the service provided by a lottery—the opportunity for

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[33] Lotteries that are part of a state's legal entity sometimes issue separate fund or departmental financial statements, as discussed in chapter 16.

financial gain—is provided to anyone who chooses to participate. When prizes are awarded to winners and financial gain is achieved, the lottery operation does not exclusively, or almost exclusively, benefit the primary government as an institution.

12.108 Lottery prize costs normally should be accrued based on a percentage of ticket sales revenues. For example, if a lottery game is designed so that 40 percent of ticket sales is paid out as prizes, prize costs of 40 cents should be accrued for each dollar of revenue recognized for ticket sales. Accounting and financial reporting considerations may arise relating to (*a*) prizes won and claimed but not yet paid, (*b*) prizes won but not yet claimed, and (*c*) games-in-progress at year-end, as discussed in paragraphs 12.109–.110.

12.109 Prize winners generally can choose to have large prizes paid to them (*a*) currently at present value in a lump sum or (*b*) over a period of years at future values. If the periodic payment option is used, the state may finance the prize liability, for example, by purchasing (*a*) an annuity from an insurance company or (*b*) U.S. Treasury securities matched in timing and amount to the future payments. If a purchased annuity is in the name of the prize winner, the state should not recognize a liability or asset because it has discharged the primary liability. However, the state may need to disclose in the financial statements that a contingent liability exists. (Chapter 8 discusses the accounting, financial reporting, and auditing considerations for contingent liabilities.) Further, if the state does not purchase an annuity in the name of the prize winner, any assets specifically identified to pay the liability (such as U.S. Treasury securities matched in timing and amount to the future payments) and the present value of the liability should be included in the state's financial statements.

12.110 The prize liability (measured using present value) should include lottery prizes that have been won but not yet claimed as well as anticipated prizes for games-in-progress at year-end. In addition, the gain contingency guidance of GASB Statement No. 62 paragraphs 96–113, as amended (discussed in chapter 8 of this guide), should be used to account for prizes that will be forfeited because the winners will not claim them within the required time frame. State statutes may restrict the use of forfeited prizes to future lottery games or other specific other purposes.

12.111 Lottery tickets generally are sold in stores and other designated locations through both on-line computer access to the state lottery agency and "instant" games that use paper tickets. The state should estimate the amounts receivable from sales locations for lottery tickets, adjusted for an allowance for uncollectible receivables. The auditor is responsible for evaluating the reasonableness of accounting estimates made by management.

12.112 Often, state law requires a certain percentage of lottery sales revenues to be used for particular programs, such as elementary and secondary education or services to the elderly. GASB IG 2015-1 question 7.39.3 indicates that such lottery sales revenues should be reported as program revenues of the lottery function, not of the function that the revenues support. That guidance is supported by GASB Statement No. 37 paragraph 12, which states that for identifying the function to which a program revenue pertains, the determining factor for charges for services is which function generates the revenue.

Escheat Property

12.113 Escheat property is property that eventually reverts to a government (usually a state) because legal claimants or heirs have not been identified.

Many state laws provide that a rightful owner or heir can reclaim escheat property (or its value) into perpetuity. Because large portions of escheat property are never reclaimed, most states use some of that property to finance operations.

12.114 GASB Statement No. 21, *Accounting for Escheat Property*, as amended, contains the standards for reporting escheat property. In addition, when transactions involving escheat property are nonexchange transactions, the provisions of GASB Statement No. 33, as amended, apply to the recognition of assets, revenue, liabilities, and expenditures and expenses. GASB Statement No. 37, as amended, states that escheat property generally should be reported as an asset in the governmental or proprietary fund to which the property ultimately escheats. Escheat property held for individuals, private organizations, or another government should be reported in a private-purpose trust fund or in an agency fund, as appropriate, or in the governmental or proprietary fund in which escheat property is otherwise reported, with a corresponding liability. If reported in a governmental or proprietary fund, escheat revenue should be reduced and a fund liability reported to the extent that it is probable that the escheat property will be reclaimed and paid to claimants. The liability should represent the best estimate of the amount ultimately expected to be reclaimed and paid, giving effect to such factors as previous and current trends in amounts reclaimed and paid relative to amounts escheated, and anticipated changes in those trends. Payments to claimants should reduce the liability.

12.115 In the government-wide financial statements, escheat-related balances and transactions should be measured using the economic resources measurement focus and the accrual basis of accounting. However, such balances and transactions reported in private-purpose trust or agency funds should (like all fiduciary funds) not be reported in the government-wide financial statements.

12.116 The auditor should consider determining whether the government has established accounting policies for escheat property, including noncash escheat property, and applied them consistently. The auditor also might consider evaluating the government's support for its measure of the amounts payable to claimants.

State Tuition Programs

12.117 States administer Qualified State Tuition Programs (QSTPs), which permit participants to pay currently for or to save money towards future college costs in tax-advantaged programs. QSTPs are governed by the IRC and generally fall into one of two categories: prepaid tuition plans and savings plans. With prepaid tuition plans, participants pay for years or units of education at current tuition rates and receive those years or units of education in the future even though tuition rates will have increased. With savings plans, participants save money in a special account that offers a variable rate of return and which may guarantee a minimum rate of return.

12.118 Although the IRC contains some basic requirements, each state-sponsored program varies and each state controls how contributions are to be invested. Auditors should consider the need to evaluate a state's compliance with legal and contractual provisions governing these programs. (See paragraph 12.10.) The fund type to use to report QSTPs depends on the facts and circumstances surrounding a particular program. However, the auditor should consider whether the state has reported an estimated liability for future payments to or on behalf of plan participants that is appropriate to the financial statements in which the program is reported.

Multistate Legal Settlements, Including Tobacco Settlement Resources

GASB Statement No. 48

12.119 GASB Statement No. 48, as amended, discusses exchanges by governments of interests in their expected cash flows from collecting specific receivables or specific future revenues, such as future revenues due from commercial tobacco companies as a result of a settlement of a lawsuit brought by the states, for immediate cash payments. The statement provides standards for determining whether such exchanges should be classified as sales or as collateralized borrowing transactions. See chapter 6 of this guide for a discussion of the provisions of GASB Statement No. 48, as amended.[34]

12.120 States sometimes have common litigation against various parties, and settle that litigation jointly, often leading to large amounts of payments to be received over several years. GASB Technical Bulletin (TB) No. 2004-1, *Tobacco Settlement Recognition and Financial Reporting Entity Issues*, addresses accounting by state and certain local governments (referred to as *settling governments*) for transactions relating to the multistate settlement that releases participating tobacco companies from present and future smoking-related claims by the states in exchange for perpetual annual payments to the settling governments. Some settling governments have created legally separate entities, referred to as TSAs, to issue tobacco settlement revenue debt that is backed by the rights to all or a portion of the settling governments' future tobacco settlement resources (TSRs).[35] GASB TB No. 2004-1 provides that a TSA generally should be reported as a blended component unit of the settling government that created it. Certain conditions, however, may exist that would result in other reporting, for example, presentation of the TSA as a discretely presented component unit. The auditor could consider evaluating whether management's conclusions about whether and how to report a TSA as a component unit are appropriate.

12.121 GASB TB No. 2004-1 also addresses how settling governments and TSAs should have recognized assets and revenue for TSR payments. GASB TB No. 2004-1 states that TSRs are exchange transactions and settling governments and TSAs should recognize assets and revenue for TSRs based on

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[34] GASB TB No. 2004-1, *Tobacco Settlement Recognition and Financial Reporting Entity Issues*, paragraphs 16–23 were superseded by GASB Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues*, as amended. However, entities that consummated transactions that qualify as sales of such revenues prior to the effective date of GASB Statement No. 48—financial statements for periods beginning after December 15, 2006—do not have to retroactively apply the deferral provisions in paragraph 14 of the statement. The practical effect of that provision is that entities that previously recognized all of the revenue from the sale of tobacco settlement revenues upon their sale do not have to restate their financial statements to defer the revenue from the sale that otherwise would be required by GASB Statement No. 48. GASB Statement No. 65, *Items Previously Reported as Assets and Liabilities*, further amends paragraph 14 of GASB Statement No. 48 by requiring the transferor government to report the proceeds from the sale of future revenue as a deferred inflow of resources in both the government-wide and fund financial statements if (*a*) the transaction was with parties outside the financial reporting entity and (*b*) the future revenue sold was not recognized previously because the event that would have resulted in revenue recognition had not yet occurred (for example, tobacco settlement revenues). See chapter 6, "Revenues and Receivables," of this guide for a discussion of the provisions of GASB Statement No. 48.

[35] Tobacco Settlement Authorities are financing authorities. See the discussion of the accounting and financial reporting requirements for financing authorities in the section of this chapter titled "Specific Guidance for Special-Purpose Governments."

the domestic shipment of cigarettes (sales). Because annual TSR payments are based on cigarette sales from the preceding calendar year, governments should estimate accrued TSRs that derive from sales from January 1 to their respective fiscal year-ends. Under the modified accrual basis of accounting, revenue should be recognized to the extent that the event occurs and resources become available.

12.122 Although the tobacco Master Settlement Agreement between the states and tobacco companies imposed no binding restrictions on the use of the TSRs, many states have enacted budgetary or other legislation providing for specific uses for the payments. The auditor should consider evaluating whether the resources have been spent for the specified purposes and whether the legislation should result in the reporting of restrictions of the resulting net position (or fund balances) or commitments of fund balance (or, in governmental funds, of fund balance designations). In addition, the auditor should consider evaluating the settling government's estimate of accrued revenue that derives from cigarette sales from January 1 to its fiscal year-end.

12.123 With other multistate legal settlements, the gain contingency provisions of GASB Statement No. 62 paragraphs 96–113, as amended (discussed in chapter 8 of this guide) may apply. The auditor should consider the terms of the settlement in evaluating a state's application of the provisions of GASB Statement No. 62 paragraphs 96–113, as amended.

Chapter 13

Defined Benefit Pension Plans (Plan & Employer Considerations)

For purposes of this chapter, the changes resulting from GASB Statement No. 73, *Accounting and Financial Reporting for Pensions and Related Assets That Are Not within the Scope of GASB Statement 68, and Amendments to Certain Provisions of GASB Statements 67 and 68*, and GASB Statement No. 82, *Pension Issues—an amendment of GASB Statements No. 67, No. 68, and No. 73*, have been incorporated directly into the chapter rather than through the use of shaded text or update boxes (see preface).

Introduction

13.01 This chapter addresses accounting, financial reporting, and auditing considerations for governmental defined benefit pension plans and participating governmental employers in those plans. The chapter includes the following sections:

- Part I—Plan Accounting, Financial Reporting, and Auditing Considerations for Defined Benefit Pension Plans Administered Through a Qualifying Trust
- Part II—Employer Accounting, Financial Reporting, and Auditing Considerations: Single and Agent Employers
- Part III—Employer Accounting, Financial Reporting, and Auditing Considerations: Cost-Sharing Employers
- Appendix A—Governmental Employer Participation in Agent Multiple-Employer Plans: Issues Related to Information for Employer Reporting
- Appendix B—Governmental Employer Participation in Cost-Sharing Multiple-Employer Plans: Issues Related to Information for Employer Reporting

Emphasis Point

The sections of this chapter address the topics related to accounting, financial reporting, and auditing considerations for governmental defined benefit pension plans and participating governmental employers in those plans. Because the pension-related elements for employers are dependent on information maintained by the plan, significant interaction among the plans, participating employers, and related auditors is necessary to corroborate the pension amounts in employer financial statements.

Part I of this chapter addresses specific accounting and auditing considerations for plan financial statements prepared in accordance with GASB Statement No. 67, *Financial Reporting for Pension Plans—an amendment of GASB Statement No. 25*, as amended. Auditors of multiple-employer plans will likely also be engaged to provide assurance services on additional information that will be provided by plans to participating employers to facilitate employer reporting. Appendixes A–B of this chapter provide guidance when plan auditors are engaged to provide such assurance services and also discuss related materiality considerations, which may be at a lower level than that of the financial statement audit. Therefore, plan auditors may want to consider the guidance in appendixes A–B when planning the audit of the plan financial statements to gain an understanding of the materiality differences in order effectively coordinate the work performed for both of the engagements.

Parts II and III of this chapter address specific accounting and auditing considerations for employers participating in defined benefit pension plans in accordance with GASB Statement No. 68, *Accounting and Financial Reporting for Pensions—an amendment of GASB Statement No. 27*, as amended. Parts II and III make reference to suggested solutions to multiple-employer plans discussed in appendixes A–B. Although the guidance in these appendixes is integral to the audit of the employer's financial statements, these appendixes are *other auditing publications* and are nonauthoritative.

Part II of this chapter also addresses specific accounting and auditing considerations for governments whose employees are provided with pensions not administered through a qualifying trust which are addressed in GASB Statement No. 73 (that is, not within the scope of GASB Statement No. 68). Given the nature of these pensions, there is no plan reporting, thus all the accounting and financial reporting described in GASB Statement No. 73 is at the employer level and is similar to GASB Statement No. 68 but with certain modifications. Because of the similarities with GASB Statement No. 68, this chapter only specifically addresses GASB Statement No. 73 requirements and auditor guidance that differ from GASB Statement No. 68. Those differences are called out in boxes titled, "Considerations for Pensions Not Administered Through a Qualifying Trust." Otherwise, the remainder of the guidance in part II may be considered for plans not administered through a qualifying trust.

13.02 Governments establish plans in various ways to provide postemployment benefits. A common approach is to use a public employee retirement system (PERS). A PERS is a special-purpose government that administers one or more defined benefit pension plans and sometimes other types of employee benefit plans—including defined contribution, deferred compensation, and other postemployment benefit plans.[1]

13.03 GASB Statement No. 67 establishes accounting and financial reporting for pension plans that are administered through qualifying trusts or equivalent arrangements in which

- contributions from employers and nonemployer contributing entities to the pension plan and earnings on those contributions are irrevocable.
- pension plan assets are dedicated to providing pensions to plan members in accordance with the benefit terms.
- pension plan assets are legally protected from the creditors of employers, nonemployer contributing entities, and the pension plan

[1] Guidance on other types of employee benefit plans is included in chapter 12, "Special Purpose and State Governments," and chapter 14, "Defined Benefit Postemployment Benefits Other than Pensions (Plan & Employer Considerations)," of this guide.

administrator. If the plan is a defined benefit pension plan, plan assets also are legally protected from creditors of the plan members.

13.04 GASB Statement No. 68 establishes accounting and financial reporting for pensions provided to the employees of state and local government employers through pension plans that are administered through a trust or equivalent arrangement that meets the criteria in paragraph 13.03 (qualifying trust). GASB Statement No. 73 establishes accounting and financial reporting requirements for employers that provide pensions through pension plans that are not administered through a trust or equivalent arrangement that has the criteria in paragraph 13.03 (hereafter referred to as *pensions not administered through a qualifying trust*). GASB Statement No. 78, *Pensions Provided Through Certain Multiple-Employer Defined Benefit Pension Plans* establishes separate requirements for employers that participate in certain private or federally sponsored multiple-employer defined benefit pension plans. Given the limited applicability of GASB Statement No. 78, this chapter does not address the accounting or auditing considerations of governments subject to it.

13.05 Although GASB Statement Nos. 67, 68, and 73 apply to both defined benefit and defined contribution pension plans, this chapter focuses on defined benefit pension plans. Certain plans may have characteristics of both defined benefit and defined contribution plans. Paragraph 7 of GASB Statement No. 67 specifies three criteria, all of which must be met, for a plan's classification as a defined contribution plan.

13.06 Although many of the audit objectives for governmental plans are similar to those for private-sector pension plans, the Employee Retirement Income Security Act of 1974 (ERISA) does not apply to most governmental entities.[2] Instead, state and local laws and regulations that govern the operations of a pension plan may affect allowable investments, investment income allocation, funding requirements, member eligibility and vesting, and payments to plan members and beneficiaries. The regulatory environment for governmental plans will vary significantly from state to state as regulations often come from multiple sources, including state statutes or local government ordinances.

Nature of Transactions

Types of Defined Benefit Pension Plans

13.07 *Defined benefit pensions* are pensions for which the income or other benefits that the plan member will receive at or after separation from employment are defined by the benefit terms. The pensions may be stated as a specified dollar amount or as an amount that is calculated based on one or more factors such as age, years of service, and compensation.

13.08 Pensions include retirement income and, if provided through a pension plan, postemployment benefits other than retirement income (such as death benefits, life insurance, and disability benefits). Pensions do not include

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[2] Certain governmental plans of Indian tribes and educational institutions that report in accordance with generally accepted accounting principles for state and local governmental entities may be subject to Employee Retirement Income Security Act of 1974 (ERISA) and DOL audit and reporting requirements. The AICPA Audit and Accounting Guide *Employee Benefit Plans* includes guidance on plans subject to ERISA and Department of Labor audit and reporting requirements.

postemployment health care and termination benefits.[3] Defined benefit pension plans are classified according to (*a*) the number of employers whose employees are provided with pensions through the pension plan and (*b*) whether pension obligations and pension plan assets are shared. For purposes of this classification, a primary government and its component units are considered to be one employer.[4] Accordingly, plans are classified in one of the following categories:

- *Single-employer* pension benefits are provided to the employees of only one employer.
- *Cost-sharing multiple-employer (cost-sharing)* pension obligations to the employees of more than one employer are pooled and pension plan assets can be used to pay the benefits of the employees of any employer that provides pensions through the pension plan.
- *Agent multiple-employer (agent)* pension plan assets are pooled for investment purposes, but separate accounts are maintained for each individual employer so that each employer's share of the pooled assets is legally available to pay the benefits of only its employees.

Considerations for Pensions Not Administered Through a Qualifying Trust

Defined benefit pension plans can be offered through insured plans (defined in paragraph 14 of GASB Statement No. 73) whereby premiums are paid to an insurance company while employees are in active service, in return for which the insurance company unconditionally undertakes an obligation to pay the pensions as defined in the pension plan terms. Defined benefit pension plans other than insured plans are classified according to the number of employers whose employees are provided with pensions through the plan.

GASB Statement No. 73 addresses plans as either single-employer pension plans or multiple-employer defined benefit pension plans. For employers that provide benefits through multiple-employer defined benefit pension plans that are not administered through a qualifying trust, each individual employer is considered to be participating in their own plan, similar to a single-employer plan, that is not administered through a qualifying trust

Number of Defined Benefit Pension Plans

13.09 As discussed in paragraphs 13–14 of GASB Statement Nos. 67 and 68, respectively, if (on an ongoing basis) all assets accumulated in a defined benefit pension plan for the payment of benefits may legally be used to pay benefits (including refunds of employee contributions) to any of the plan members (employees), the total assets should be reported as assets of one defined benefit pension plan. This would be the case (that is, there would be only one plan) even if administrative policy requires that separate reserves, funds, or accounts for specific groups of plan members (employees), employers, or types

[3] See footnote 1.

[4] GASB *Implementation Guide 2015-1* questions items 5.125.1–3 address the reporting by primary governments and component units.

of benefits be maintained or separate actuarial valuations are performed for different classes of plan members (employees) or different groups of plan members (employees) because different contribution rates may apply for each class or group depending on the applicable benefit structures, benefit formulas, or other factors.

13.10 A separate defined benefit pension plan should be reported for a portion of the total assets, even if the assets are pooled with other assets for investment purposes, if that portion of assets meets both of the following criteria:

- The portion of assets is accumulated solely for the payment of benefits to certain classes or groups of plan members or to plan members who are active or inactive employees of certain entities (for example, state government employees).
- The portion of assets may not legally be used to pay benefits to other classes or groups of plan members or other entities' plan members (for example, local government employees).

Relevance of Census Data

13.11 The measurement of certain financial statement elements of defined benefit pension plan financial statements (for example, total pension liability, contributions, contributions receivable, and benefit payments) are dependent on plan members' demographic data, which is referred to as *census data*. Similarly, certain financial statement elements of employers that participate in defined benefit pension plans (that is, net pension liability, deferred outflows of resources, deferred inflows of resources, and pension expense) are also dependent on members' census data. Thus, the relevance of census data to the measurement of certain financial statement elements depends on the basis upon which those financial statement elements are calculated. The relevance of census data also depends on the type of plan (that is, single-employer, cost-sharing, or agent), as accounting and disclosures differ.

13.12 When the plan and the employer are under different governance structures, different parties typically maintain the underlying records of the census data. Most commonly, employers maintain the underlying records of active members. The plan typically maintains the underlying records of plan members who are no longer employed by a participating employer (that is, inactive members). In the case of smaller single-employer plans that are under the same governance structure, often, the same individuals are responsible for maintaining all of the underlying records of the census data. The following paragraphs describe the typical process for accumulating census data when different governance structures exist for the plan and employer.

13.13 The plan typically acts as the record-keeper for census data. The plan prepares the census data file to provide to the actuary, which is based, in part, on information reported to the plan by the participating employer(s) on a periodic basis. The census data file is an accumulation of census data information reported by participating employer(s) to the plan over numerous years that is adjusted by the plan based on known events.

13.14 Census data is reported to the plan in numerous ways. It often begins with the enrollment of an employee, whether by the employer or directly by the employee, through an application process that communicates certain elements of census data—including name, Social Security number, date of birth, gender, date of hire, marital status, and position or job code.

13.15 Subsequent to enrollment, incremental changes to the census data are often reported to the plan through periodic employer (payroll) transmission reports that usually correspond with the periodic remittances of employee and employer contributions to the plan. The employer (payroll) transmission reports often include items such as pensionable wages, service credits (periods of time worked), employer contributions, and employee contributions for the period covered by the report. The plan uses the employer (payroll) transmission reports to update its records and the census data file for the current year. Similarly, other important status changes—such as position, marital status, and employment status—may be reported to the plan through a reporting mechanism other than the employer (payroll) transmission reports.

Considerations for Pensions Not Administered Through a Qualifying Trust

In the case of pensions not administered through a qualifying trust, often, the same individuals are responsible for maintaining all of the underlying records of the census data because there is not a separate entity or governance structure for the defined benefit pension plan.

Emphasis Point

When auditing the financial statements of pension plans and participating employers, auditors usually use significant amounts of *personally identifiable information* (PII). PII generally refers to any data or information about an individual that, in isolation or when combined with other data, could reasonably be used to identify or contact that person. PII includes information such as name, phone number, email address, Social Security number, account numbers, and can also include such items as fingerprints, signatures, and other biometric data. Some PII is considered "sensitive" or otherwise deserving of special consideration, particularly in the context of confidentiality. For example, certain jurisdictions explicitly define the following areas of sensitive information that require special handling: information regarding an individual's medical or health conditions; racial or ethnic origin; trade union membership; or similarly sensitive type of information. A person's first and last name is not always considered "private," but when combined with the user's Social Security number, the combination is considered protected PII under certain US laws and various state laws.

It is recommended that auditors carefully consider (1) the risks associated with the collection, processing, storage, transfer, or disposition of PII and the potential processes and controls to manage those risks through physical, procedural, and technical security measures, and (2) legal, regulatory, ethical, and professional obligations to protect PII.

Part I—Plan Accounting, Financial Reporting, and Auditing Considerations for Defined Benefit Pension Plans Administered Through a Qualifying Trust

Emphasis Point

Part I of this chapter addresses specific accounting and auditing considerations for plan financial statements prepared in accordance with GASB Statement No. 67. Auditors of multiple-employer plans will likely also be engaged to provide assurance services on additional information that will be provided by plans to participating employers to facilitate employer reporting. Appendixes A–B of this chapter provide guidance when plan auditors are engaged to provide such assurance services and also discuss related materiality considerations, which may be at a lower level than that of the financial statements audit. Therefore, plan auditors may want to consider the guidance in appendixes A–B when planning the audit of the plan financial statements to gain an understanding of the materiality differences in order to effectively coordinate the work performed for both of the engagements.

Although the guidance in these appendixes is integral to the audit of the employer's financial statements, these appendixes are *other auditing publications* and are nonauthoritative.

Accounting and Financial Reporting Considerations

General Recognition Standards

13.16 In accordance with paragraph 14 of GASB Statement No. 67, the financial statements of a defined benefit pension plan should include the following:

- A statement of fiduciary net position, which includes information about assets, deferred outflows of resources, liabilities, deferred inflows of resources, and fiduciary net position (as applicable) as of the end of the pension plan's reporting period.
- A statement of changes in fiduciary net position, which includes information about the additions to, deductions from, and net increase (or decrease) in fiduciary net position for the pension plan's reporting period.

13.17 In accordance with paragraph 140 of GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, as amended, a PERS that administers more than one defined benefit plan (pension benefits, postemployment benefits other than pensions, or both) that is administered through a qualifying trust is required to present combining financial statements for all plans administered by the system and, if applicable, required schedules for each plan. A PERS should meet this financial statement requirement by presenting (*a*) a separate column for each plan administered on the statement of fiduciary net position and the statement of changes in fiduciary net position or (*b*) combining statements for those plans as part of the basic financial statements. Chapter 4, "General Auditing

Considerations," of this guide discusses GASB guidance to preparers on materiality determinations.

Considerations for Pensions Not Administered Through a Qualifying Trust

In accordance with paragraphs 115–116 of GASB Statement No. 73, if a pension plan is not administered through a qualifying trust, any assets accumulated for pension purposes should continue to be reported as assets of the employer or nonemployer contributing entity. When a government holds assets in a fiduciary capacity (for example, for other governments that are not included in the reporting entity), those assets should be reported in an agency fund. Balances reported in the agency fund should exclude amounts that pertain to the employer or nonemployer contributing entity that reports the agency fund.

Update 13-1 *Fiduciary Activities*

GASB Statement No. 84, *Fiduciary Activities*, establishes criteria for identifying and reporting fiduciary activities. The criteria for identification of fiduciary activities primarily focuses on (*a*) whether a government controls the assets of the fiduciary activity and (*b*) the beneficiaries with whom a fiduciary relationship exists.

Governments with activities meeting the criteria will present a statement of fiduciary net position and a statement of changes in fiduciary net position, with certain exceptions.

There are four classifications of fiduciary funds described in GASB Statement No. 84: (1) pension (and other employee benefit) trust funds, (2) investment trust funds, (3) private-purpose trust funds, and (4) custodial funds. Custodial funds should report fiduciary activities that are not held in a trust or equivalent arrangement that meets specific criteria. Note that agency funds will no longer be reported upon application of this statement.

The statement was issued in January 2017 and is effective for fiscal years beginning after December 15, 2018. Earlier application is encouraged.

Upon its effective date, GASB Statement No. 84 will affect the guidance in this chapter.

The full text of the statement is available on GASB's website at www.gasb.org.

Statement of Fiduciary Net Position

13.18 In accordance with paragraph 15 of GASB Statement No. 67, pension plan assets should be subdivided into (*a*) the major categories of assets held (for example, cash and cash equivalents, receivables, investments, and assets used in pension plan operations) and (*b*) the principal components of the receivables and investments categories.

13.19 *Receivables*. In accordance with paragraph 16 of GASB Statement No. 67, receivables are generally short term and consist of contributions due at the end of the reporting period. Amounts recognized as receivables for contributions should include only those due pursuant to legal requirements. In accordance with paragraph 17 of GASB Statement No. 67, receivables for contributions that are payable to the pension plan more than one year after the end of the reporting period (for example, pursuant to an installment contract) should be recognized in full in the period the receivable arises.

13.20 *Investments*. In accordance with paragraph 18 of GASB Statement No. 67, as amended, purchases and sales of investments should be recorded on a trade date basis. Except as otherwise outlined in paragraph 69 of GASB Statement No. 72, *Fair Value Measurement and Application*, as amended, investments should be reported at fair value. Chapter 5, "Investments, Certain Equity Interests, and Derivatives," of this guide discusses reporting investments at fair value.

13.21 *Liabilities.* As discussed in paragraph 20 of GASB Statement No. 67, liabilities generally consist of benefits due to plan members and accrued investment and administrative expenses. Pension plan liabilities for benefits should be recognized when the benefits are currently due and payable in accordance with the benefit terms.

13.22 *Fiduciary Net Position.* As discussed in paragraph 21 of GASB Statement No. 67, assets, plus deferred outflows of resources, less liabilities, less deferred inflows of resources at the end of the pension plan's reporting period, should be reported as net position restricted for pensions.

Statement of Changes in Fiduciary Net Position

13.23 Paragraph 22 of GASB Statement No. 67 addresses the additions section of the statement of changes in fiduciary net position, which should separately display contributions from employers, contributions from nonemployer contributing entities, contributions from plan members, and net investment income, including separate display of investment income and investment expense.[5]

> ***Emphasis Point***
>
> GASB Statement No. 67 defines *nonemployer contributing entities* as entities that make contributions to a pension plan that is used to provide pensions to the employees of other entities. For purposes of the statement, plan members are not considered nonemployer contributing entities.
>
> Thus, the additions section would include contributions received directly by the plan from any nonemployer contributing entity, whether in a special funding situation or not.

13.24 Investment income includes the following:

a. The net increase (decrease) in the fair value of pension plan investments

b. Interest income, dividend income, and other income not included in (*a*).

[5] As discussed in paragraph 26 of GASB Statement No. 67, *Financial Reporting for Pension Plans—an amendment of GASB Statement No. 25*, as amended, if investment-related costs can be separated from investment income and administrative expenses of the plan, they should be reported as investment expense.

Components (*a*) and (*b*) of investment income may be separately displayed or combined and reported as one amount.

13.25 Paragraph 24 of GASB Statement No. 67 states that the net increase (decrease) in fair value of investments should include realized gains and losses on investments that were both bought and sold during the period. Realized and unrealized gains and losses should not be separately displayed in the financial statements. Realized gains and losses, computed as the difference between the proceeds of sale and the original cost of the investments sold, may be disclosed in notes to financial statements.

13.26 Paragraph 25 of GASB Statement No. 67 states that the deductions section of the statement of changes in fiduciary net position should, at a minimum, separately display benefit payments, including refunds of plan member contributions and administrative expenses.

13.27 The difference between total additions and total deductions is reported as the net increase (decrease) in net position.

Note Disclosures and Required Supplementary Information

13.28 Paragraph 30 of GASB Statement No. 67, as amended, addresses the note disclosures in the financial statements applicable to all plans, regardless of type. The following are among the categories of required disclosures:

- Plan description
- Pension plan investments
- Receivables
- Allocated insurance contracts
- Reserves
- Deferred retirement option program balances

13.29 It is important to note that the plan should include other applicable disclosures required by other GASB standards as well as required supplementary information (RSI) (for example, management's discussion and analysis).

Additional Considerations for Single-Employer and Cost-Sharing Plans

13.30 Paragraph 31 of GASB Statement No. 67 addresses additional note disclosure requirements of single-employer and cost-sharing plans. The following are among the required disclosures:

- Components of net pension liability, including total pension liability, plan's fiduciary net position, net pension liability, and pension plan's fiduciary net position as a percentage of the total pension liability[6]
- Significant assumptions used to measure total pension liability, including inflation, salary changes, discount rate, and mortality
- Date of actuarial valuation on which the total pension liability is based

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[6] In this guide, references to a net pension liability also apply to situations in which the fiduciary net position exceeds the total pension liability resulting in a net pension asset.

13.31 In addition, single-employer and cost-sharing plans have to present certain 10-year schedules of RSI[7] as discussed in paragraph 32 of GASB Statement No. 67, as amended including information on the changes in the net pension liability, key ratios, information on contributions, and the annual money-weighted rate of return on pension plan investments.

Additional Considerations for Agent Plans

13.32 Agent plans do not have any specific note disclosure requirements or RSI related to pension liabilities or actuarial information.

13.33 Paragraph 33 of GASB Statement No. 67 requires agent plans to disclose as RSI a 10-year schedule of the annual money-weighted rate of return on pension plan investments.[8]

Measurement of the Net Pension Liability Single-Employer and Cost-Sharing Plans

13.34 As discussed in paragraph 35 of GASB Statement No. 67, the net pension liability equals the total pension liability for the pension plan, less the fiduciary net position of the plan. Total pension liability is the actuarial present value of projected benefit payments attributed to past employee service. Fiduciary net position is determined using the same valuation methods that are used for the plan's financial reporting.

13.35 Determining the total pension liability is a three step process: (1) projecting future benefit payments, (2) discounting projected future benefit payments to present value, and (3) attributing present value of projected future benefits to past and future periods.

Timing and Frequency of Actuarial Valuations

13.36 Paragraph 37 of GASB Statement No. 67 indicates that the total pension liability[9] should be determined by (*a*) an *actuarial valuation* as of the pension plan's most recent fiscal year-end or (*b*) the use of update procedures to roll forward to the pension plan's most recent fiscal year-end amounts from an actuarial valuation as of no more than 24 months earlier than the pension plan's most recent fiscal year-end. If update procedures are used and significant changes occur between the *actuarial valuation date* and the pension plan's fiscal year-end, professional judgment should be used to determine the extent of procedures needed to roll forward the measurement from the actuarial valuation to the pension plan's fiscal year-end, and consideration should be given to whether a new actuarial valuation is needed. For purposes of this determination, the effects of changes in the discount rate resulting from changes in the pension plan's fiduciary net position or from changes in the municipal bond rate, if applicable, should be among the factors evaluated. For financial reporting purposes, an actuarial valuation of the total pension liability should be

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[7] Chapters 4, "General Auditing Considerations," and 16, "Audit Reporting," of this guide discuss the auditor's responsibility for required supplementary information, including auditor reporting.

[8] See footnote 5.

[9] In accordance with paragraph 38 of GASB Statement No. 67, unless otherwise specified by GASB Statement No. 67, the selection of all assumptions used in determining the total pension liability and related measures should be made in conformity with Actuarial Standards of Practice issued by the Actuarial Standards Board without deviation. The pension plan, employer, and, if any, governmental nonemployer contributing entities that make contributions to the pension plan should use the same assumptions when measuring similar or related pension information.

performed at least biennially. However, GASB encourages more frequent actuarial valuations.

> ***Emphasis Point***
>
> It is important for plans to consider the needs of participating employers in determining the timing and frequency of actuarial valuations, especially if the plan chooses to perform actuarial valuations on a biennial basis. GASB Statement No. 67 requires the actuarial valuation to be performed within 24 months of the plan's fiscal year-end. GASB Statement No. 68 requires the total pension liability for employers to be determined by an actuarial valuation that is within 30 months and 1 day from the employer's most recent fiscal year-end. It is possible for a plan's valuation to be in compliance with the requirements of GASB Statement No. 67 but be outside the time frame set forth for employers.

Projection of Benefit Payments

13.37 In accordance with paragraph 39 of GASB Statement 67, projected benefit payments should include all benefits to be provided to current active and inactive members through the pension plan in accordance with the benefit terms and any additional legal agreements to provide benefits that are in force at the pension plan's fiscal year-end. In addition, projected benefit payments[10] should include the effects of the following:

a. Projected ad hoc postemployment benefit changes, including ad hoc cost-of-living adjustments (ad hoc COLAs), to the extent that they are considered to be substantively automatic[11]

b. Projected salary changes (in circumstances in which the pension formula incorporates future compensation levels)

c. Projected service credits (both in determining a member's probable eligibility for benefits and in the projection of benefit payments in circumstances in which the pension formula incorporates years of service)

Discounting Projected Future Benefits

Discount Rate

13.38 For purposes of applying GASB Statement No. 67, the discount rate is the single rate of return that, when applied to all projected benefit payments, results in an actuarial present value of projected benefit payments equal to the total of the actuarial present values determined in conformity with paragraph

[10] In accordance with paragraph 19 of GASB Statement No. 67, benefit payments to be provided by means of an *allocated insurance contract* should be excluded from projected benefit payments if (*a*) the contract irrevocably transfers to the insurer the responsibility for providing the benefits, (*b*) all required payments to acquire the contract have been made, and (*c*) the likelihood is remote that the employer or the pension plan will be required to make additional payments to satisfy the benefit payments covered by the contract.

[11] Considerations that might be relevant in determining whether such changes are substantively automatic include the historical pattern of granting the changes, the consistency in the amounts of the changes or in the amounts of the changes relative to a defined cost-of-living or inflation index, and whether there is evidence to conclude that changes might not continue to be granted in the future despite what might otherwise be a pattern that would indicate such changes are substantively automatic.

40 of GASB Statement No. 67, as follows. A single blended discount rate should be based on the following:

a. The long-term expected rate of return on pension plan investments that are expected to be used to finance the payment of benefits, to the extent that plan fiduciary net position is projected to be sufficient to make projected benefit payments and plan assets are expected to be invested using a strategy to achieve that return; and

b. A yield or index rate for 20-year, tax-exempt general obligation municipal bonds with an average rating of AA/Aa or higher (or equivalent quality on another rating scale), to the extent that the conditions in (*a*) are not met.

Comparing Projections of the Pension Plan's Fiduciary Net Position to Projected Benefit Payments

13.39 As discussed in paragraph 41 of GASB Statement No. 67, for purposes of applying the discount rate, the amount of the pension plan's projected fiduciary net position and the amount of projected benefit payments should be compared in each period of projected benefit payments. Projections of the pension plan's fiduciary net position should incorporate all cash flows for (*a*) contributions from employers and nonemployer contributing entities, if any, intended to finance benefits of current active and inactive members (status at the pension plan's fiscal year-end), and (*b*) all cash flows for contributions from current active members.[12]

13.40 Paragraph 42 of GASB Statement No. 67 states that professional judgment should be applied to project cash flows for contributions from employers and nonemployer contributing entities in circumstances in which (*a*) those contribution amounts are established by statute or contract or (*b*) a formal, written policy related to those contributions exists. Application of professional judgment should consider the most recent five-year contribution history of the employers and nonemployer contributing entities as a key indicator of future contributions from those sources and should reflect all other known events and conditions. In circumstances other than those described in (*a*) and (*b*), the amount of projected cash flows for contributions from employers and nonemployer contributing entities should be limited to an average of contributions from those sources over the most recent five-year period and may be modified based on consideration of subsequent events.

Calculating the Discount Rate

13.41 In accordance with paragraph 44 of GASB Statement No. 67, for each future period, if (*a*) the amount of the pension plan's fiduciary net position is projected to be greater than or equal to the benefit payments that are projected to be made in that period and (*b*) pension plan assets up to that point are expected to be invested using a strategy to achieve the long-term expected rate of return, the actuarial present value of benefit payments projected to be made in the period should be determined using the long-term expected rate of return on those investments.

[12] Paragraph 43 of GASB Statement No. 67 states, if the evaluations required by paragraph 41 can be made with sufficient reliability without a separate projection of cash flows into and out of the pension plan, alternative methods may be applied in making the evaluations.

13.42 In accordance with paragraph 44 of GASB Statement No. 67, the long-term expected rate of return should be based on the nature and mix of current and expected pension plan investments over a period representative of the expected length of time between (*a*) the point at which a member begins to provide service to the employer and (*b*) the point at which all benefits to the member have been paid. For this purpose, the long-term expected rate of return should be determined net of pension plan investment expense but without reduction for pension plan administrative expense. The municipal bond rate previously discussed in paragraph 13.38*b* should be used to calculate the actuarial present value of all other benefit payments.

Attributing the Actuarial Present Value of Projected Benefit Payments to Periods

13.43 Attribution of the present value of projected future benefit payments to specific periods should be based on the entry age actuarial cost method in accordance with the requirements of paragraph 46 of GASB Statement No. 67.

Auditing Considerations for the Pension Plan

13.44 This section discusses audit considerations, including describing the relevant assertions when auditing the pension plan's basic financial statements (whether as a stand-alone plan or a pension trust fund included within the primary government's financial statements). This section does not include all risks or all procedures that could apply to such audits in accordance with generally accepted auditing standards; instead, this section focuses on specific considerations for testing certain financial statement elements. The examples of substantive audit procedures are not considered required procedures, nor are they all-inclusive.

Emphasis Point

As discussed in the emphasis point after paragraph 13.01, the pension-related elements for employers (discussed in parts II and III of this chapter) are dependent on information maintained by the plan requiring significant interaction between the plans, participating employers, and auditors for purposes of corroborating pension amounts in employer financial statements.

The following section discusses specific auditing considerations for plan financial statements prepared in accordance with GASB Statement No. 67. Appendixes A–B of this chapter provide guidance when plan auditors are engaged to provide such assurance services and also discuss related materiality considerations, which may be at a lower level than that of the financial statement audit. Therefore, plan auditors may want to consider the guidance in appendixes A–B when planning the audit of the plan financial statements to gain an understanding of the materiality differences in order to effectively coordinate the work performed for both of the engagements.

Although the guidance in these appendixes is integral to the audit of the employer's financial statements, these appendixes are *other auditing publications* and are nonauthoritative.

Determining Audit Strategy

13.45 Determining the strategy for the pension plan audit requires the auditor to understand the type of plan (that is, single-employer, cost-sharing, or agent plan, as defined in paragraph 13.08), whether there are multiple plans in a system, and what activities the various parties perform. Example activities include investing and holding plan assets, maintaining records, determining pension liabilities, receiving contributions, and disbursing benefits. Additionally, understanding the key provisions (for example, eligibility, contributions, vesting, and benefit payments) of the plan document, which often is included in state statutes, will assist the auditor in designing an appropriate audit strategy.

13.46 Once the auditor understands the type of plan and the party responsible for each activity, understanding the risks of what can go wrong to assess material risk of misstatement surrounding those activities is necessary to determine the nature, timing, and extent of testing. (See chapter 4 for a discussion of the auditor's risk assessment and response to assessed audit risk.) Given the interaction between the plan and participating employers, there are often both shared and divided responsibilities for certain elements.

13.47 The auditor should apply the concept of opinion units in planning, performing, evaluating the results of, and reporting on financial statements that include defined benefit pension plans. Chapter 4 discusses opinion units required for an audit of a government's basic financial statements, which includes the following points:

a. A general purpose government that includes a defined benefit pension plan as part of its financial reporting entity presents the plan as part of the aggregate remaining fund information.

b. A government that engages only in fiduciary activities has only one opinion unit that represents aggregate remaining fund information.

For a PERS with more than one defined benefit pension plan that presents separate financial statements for each plan (as required by GASB Statement No. 67), those separate plan financial statements do not represent separate opinion units but, rather, are aggregated into a single opinion unit. Auditors should make separate materiality determinations for each opinion unit for purposes of planning, performing, evaluating the results of, and reporting on the audit of government's basic financial statements. An auditor may be engaged to report at a lower level than the opinion unit. For example, if the auditor is engaged to report on each individual plan, the auditor should set the scope and assess materiality to align with the individual plan level of reporting.

13.48 AU-C section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* (AICPA, *Professional Standards*), requires the auditor to consider whether evaluating the entity's compliance with legal and contractual provisions is needed as part of the financial statement audit, particularly when noncompliance with state and local laws and regulations that govern the operations of a pension plan may materially affect the financial statements. As discussed in paragraph 13.06, the regulatory environment for plans will vary significantly. Chapter 4 of this guide discusses the auditor's responsibility (under AU-C section 250) to plan and perform the audit to obtain evidence about whether the financial statements are free from material misstatements arising from noncompliance with provisions of laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements. Chapter 4 also describes the auditor's responsibility regarding the provisions of laws and regulations that do not have a direct effect on the determination of material amounts and disclosures in the financial statements but compliance with which may be fundamental to the operating aspects of the business, fundamental to an entity's ability to continue its business, or necessary for the entity to avoid material penalties.

Census Data Considerations for Single-Employer and Cost-Sharing Plans

13.49 As previously discussed in paragraph 13.11, the measurement of certain financial statement elements of single-employer and cost-sharing plans depends on the completeness and accuracy of census data. The auditor's consideration of the relevant financial statement assertions that depend on census data begins with understanding the processes and controls used by management of the plan to support the completeness and accuracy of the significant elements of census data that are ultimately provided to the actuary. This would include the processes and controls over significant elements of census data received from participating employers on active members as well as the census data controlled by the plan, which typically include inactive members.

13.50 *Significant elements of census data* include those elements that, either individually or when combined with other elements, could result in a material misstatement to one or more elements of the plan's financial statements (for example, total pension liability, contributions, contributions receivable, and benefit payments). Significant elements of census data may include some or all of the following:

a. Name

b. Social Security number

c. Date of birth

d. Date of hire

e. Marital status

f. Pensionable wages

g. Service credits (periods of time worked)

h. Class of employee

i. Position or job code (or both)

j. Contributions

k. Gender

l. Date of termination or retirement

m. Spouse's date of birth

n. Employment status (active, inactive entitled to but not receiving benefits, retired)

The significance of some of these elements, all of these elements, or additional elements to any plan will be based on the impact that a particular census data element has on the measurement of a particular financial statement element.

13.51 The example audit procedures related to testing census data (including underlying data at the participating employer(s), the plan's accumulation of such data, and how the census data is reported to the actuary) are included in the section, "Census Data," beginning at paragraph 13.88 of this chapter.

13.52 The substantive procedures over census data are ordinarily based on a concept that focuses on testing incremental changes (see paragraph 13.15) to the census data file since the prior actuarial valuation, assuming (*a*) the prior year plan financial statements were audited; (*b*) there were no modifications to the auditor's report in the prior year related to census data; and (*c*) the auditor believes there is no significant risk of material misstatement due to incomplete or inaccurate census data from prior years.

Emphasis Point

Management of single-employer and cost-sharing plans is responsible for the preparation and fair presentation of financial statements, including completeness and accuracy of census data. Management is also responsible for the design, implementation, and maintenance of processes and controls relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to error or fraud.

Effective management processes and controls over census data separately identify the applicable risks of material misstatement related to the significant elements of census data for the various individual plan members because the risks may differ depending on a member's status (active or inactive). Accordingly, management of the plan would likely have different controls to address the applicable risks for active and inactive members. For example, pensionable wages are likely to be a significant element of census data for active members because compensation directly affects the calculation of the total pension liability. Conversely, pensionable wages would not be a significant element of census data for inactive members because they no longer earn wages. Therefore, management would likely have more robust processes and controls related to active members for this element.

Effective plan management processes for the census data of a plan's active members include procedures to verify the underlying payroll and personnel records of the participating employer(s) to determine that the information provided is accurate and complete. For a cost-sharing plan, the frequency and extent of such verification may be determined by the plan based on the assessed level of risk for each participating employer.

The absence of effective controls by the plan to verify underlying payroll and personnel records of participating employer census data in a single-employer or cost-sharing plan is a deficiency in internal control over financial reporting. The plan auditor should follow the guidance contained in AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*), when evaluating the significance of control deficiencies and whether they should be communicated to those charged with governance.

Cost-Sharing Plans

13.53 The nature, timing, and extent of the auditor's substantive procedures over the census data and the underlying payroll and personnel records of participating employers (discussed in paragraphs 13.88–.92) will depend on (*a*) the assessed risks of material misstatement of the relevant financial statement elements, and (*b*) whether the auditor concludes that plan management has effective processes and controls in place to determine the completeness and accuracy of census data provided to the actuary. Ordinarily, it is more efficient for the auditor to take a controls-based approach to testing census data as well as the employers' underlying payroll and personnel records when management has effective processes and controls over the census data. The audit procedures performed by the plan auditor include selecting a representative group of contributing employers each year on a rotating basis for testing eligible employees' underlying payroll and personnel records.

13.54 When planning substantive procedures, the auditor of the cost-sharing plan uses judgment in determining which employers, if any, represent individually important employers to be tested annually and separated from the remaining population to be tested on a rotating basis. For example, an auditor may decide that any employer that constitutes more than 20 percent of the pensionable wages will be considered individually important. Based on the composition of many plans, there may not be any individually important employers or they will likely be limited to one or two.

13.55 Once individually important employers have been identified, a risk-based approach may be used to determine which of the remaining employers to select for testing. The auditor may find the following qualitative factors helpful when selecting employers to test:

- The size of the employer in relation to a plan
- Past errors or control deficiencies of an employer
- Length of time since procedures under this section were last performed at an employer
- Whether there have been significant changes in an employer's workforce
- Results of internal analysis (analytical procedures) of employer information
- New or terminating employers to the plan
- Whether the financial statements of participating employers are audited and have received unmodified opinions

13.56 The frequency of procedures to be performed by the plan auditor at each employer will depend on the number of employers participating in the plan, the relative size of each employer, and the individual risk assessments. However, there often may be circumstances for which relatively small employers are not tested as part of such a cycle because they are considered to be inconsequential to the plan, both individually and when aggregated with other small employers not subject to testing.

13.57 The extent of testing depends on whether the plan has effective controls over census data reported by employers to the plan, including a plan management process for verifying the underlying payroll and personnel records of the participating employers to determine that the information provided is accurate and complete. Auditor judgment will be needed to determine the approach used to select the employers for the purpose of testing underlying payroll and personnel records.

13.58 For example, the auditor may develop an approach such that employers representing at least 5 percent of participating employers are tested at least once every 5 years. The number of participating employers that individually meet the 5-percent criterion will vary by plan and, in some cases, be limited to just a few. The auditor's approach for testing the remaining population of participating employers, which for some plans could number in the thousands, could be such that the remaining participating employers are tested to approximate a 10-year cycle.

Exhibit 13-1: Illustration of Previously Described Cost-Sharing Plan Auditor's Risk-Based Approach

Consider a plan with 3,000 participating employers for which the auditor has determined that plan management has effective controls to determine the completeness and accuracy of census data. The following is an illustration of the implementation of an auditor's risk-based approach:

- Based on the number and relative size of the participating employers, as well as a low assessed risk of material misstatement, the auditor determines that one employer constitutes more than 20 percent of pensionable wages and is individually important. Accordingly, this employer will be tested on an annual basis.
- Six employers are individually at least 5 percent of pensionable wages, thus, the 6 employers will be tested to approximate a 5-year cycle.
- The auditor then determines there are 400 very small employers that will likely never be tested because collectively they represent less than 2 percent of the total pensionable wages.
- The remaining employers (that is, 2,593) that individually represent less than 5 percent of pensionable wages will be tested to approximate a 10-year cycle.

13.59 Under such a risk-based approach, if the plan auditor cannot or does not perform census data testing at each employer selected for testing, such census data could be tested by the employer's auditor through an examination engagement in accordance with AT-C section 205, *Examination Engagements* (AICPA, *Professional Standards*). If such engagements are designed to test the assertions related to the completeness and accuracy of the census data and the selection of employers subject to the examination engagements are determined by the plan auditor, the plan auditor could then use such examination engagements as substantive evidence in lieu of the plan auditor directly performing the procedures. An example assertion regarding significant census data elements is provided in exhibit 13-2. An illustration of an examination report on a written assertion obtained from employer management is included in exhibit 13-3 of this chapter.

13.60 Even when employer auditors perform an examination engagement on census data, the plan auditor still has to determine if there is sufficient appropriate audit evidence over the completeness and accuracy of the census data underlying the plan's financial statement amounts by reviewing the attestation report and evaluating the competency of the other auditor.

13.61 It is important to understand the plan provisions when identifying significant elements of census data. Significant elements will likely include, at a minimum, those listed in the example management assertion. There will likely be additional significant elements based on the specific pension benefits (formula) of a plan.

Exhibit 13-2: Example Assertion

The significant elements of census data reported to the [*Name of Retirement* System] for the [*Name of Plan*] during the year ended June 30, 20X3, were complete and accurate based on the criteria (plan provisions) included in [*identify applicable statutes or name of plan document*]. The significant elements reported to the [*Name of Retirement System*] for the [*Name of Plan*] were as follows:

Report	***Significant Elements***
[*Name of Report*] (for example, New Employee Enrollments)	[*List significant elements*] (for example, name, Social Security number, date of birth, hire date, gender, and marital status)
[*Name of Report*] (for example, Employer Transmission Report)	[*List significant elements*] (for example, name, position or job code, hours worked, pensionable income for period, employer contribution for period, and employee contribution for period)
[*Name of Report*] (for example, Employee Status Changes)	[*List significant elements*] (for example, name, Social Security number, and new job position)

Exhibit 13-3: Illustrative Attestation Report

Independent Accountant's Report

[*Appropriate Addressee*]

We have examined management's assertion that the significant elements of census data reported by City of Example, Any State to [*Name of Retirement System*] for the [*Name of Plan*] during the year ended June 30, 20X3, were complete and accurate based on the criteria included in [*identify applicable statutes or name of plan document*]. The significant elements of census data reported to [*Name of Retirement System*] for the [*Name of Plan*] were as follows:

Report	***Significant Elements***
[*Name of Report*] (for example, New Employee Enrollments)	[*List significant elements*] (for example, name, Social Security number, date of birth, hire date, gender, and marital status)
[*Name of Report*] (for example, Employer Transmission Report)	[*List significant elements*] (for example, name, position or job code, hours worked, pensionable income for period, employer contribution for period, and employee contribution for period)
[*Name of Report*] (for example, Employee Status Changes)	[*List significant elements*] (for example, name, Social Security number, and new job position)

City of Example's management is responsible for the assertion. Our responsibility is to express an opinion on management's assertion based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform the examination to obtain reasonable assurance about whether management's assertion is fairly stated, in all material respects. An examination involves performing procedures to obtain evidence about management's assertion. The nature, timing, and extent of the procedures selected depend on our judgment, including an assessment of the risks of material misstatement of management's assertion, whether due to fraud or error. We believe that the evidence we obtained is sufficient and appropriate to provide a reasonable basis for our opinion.

In our opinion, management's assertion that significant elements of census data reported by City of Example, Any State to [*Name of Retirement System*] for the [*Name of Plan*] during the year ended June 30, 20X3, were complete and accurate based on the criteria included in [*identify applicable statutes or name of plan document*] is fairly stated, in all material respects.

This report is intended solely for the information and use of City of Example, [*Name of Plan*] and [*Name of Plan*]'s auditors and is not intended to be and should not be used by anyone other than the specified parties.

[*Practitioner's signature*]

[*Practitioner's city and state*]

[*Date of practitioner's report*]

13.62 As for the census data related to inactive members, the plan auditor can directly test records maintained by the plan to obtain sufficient appropriate evidence that the census data reported for inactive members to the actuary is complete and accurate.

Single-Employer Plans

13.63 In a single-employer plan, the risk-based approach to testing census data described previously is ordinarily not applicable. With only one employer, the plan's auditor can work with both the plan and the employer to obtain access to the underlying records of the active and inactive members. The plan auditor would also test the underlying data of a sample of members each year to obtain sufficient appropriate evidence that the census data reported to the actuary is complete and accurate. Such evidence may also be obtained through an examination engagement performed by the employer's auditor in accordance with AT-C section 205 as discussed in paragraphs 13.59–.61.

Census Data Considerations for Agent Plans

13.64 The financial statements of agent plans do not reflect any liabilities, deferred outflows of resources, deferred inflows of resources, or expenses that are based on actuarial information. It should be noted that for administrative purposes, the agent plan typically serves as the record-keeper for census data reported by the employers and is responsible for engaging an actuary to perform an actuarial valuation to determine the net pension liability for each employer. Such amounts are provided to employers by the plan and are reflected only in the employer's financial statements.

13.65 In contrast to single-employer and cost-sharing plans, auditors of agent plans generally do not need to test census data at participating employers because the plan financial statements do not include any actuarial liabilities. However, agent plans are responsible for administering the plan, including the payment of benefits based on the census data reported by the employer. Accordingly, the focus of testing is generally on the accumulation and maintenance of census data by the plan based on the plan's role as the record keeper. Paragraphs 13.94–.95 address example audit procedures to consider for agent plans related to benefit payments. Note that the responsibilities for census data from the agent employer's perspective are discussed in part II of this chapter.

Plan Investments and Related Income

13.66 In addition to the requirements and considerations discussed in chapter 4 related to the auditor's risk assessment and understanding the entity, considerations specific to plan investments may include obtaining an understanding of investment policies, investment management arrangements, valuation techniques as well as the relevant investment activities performed by plan management, trustee (or other asset custodian), and investment managers. Often, in governmental plans, the plan's investment provisions are dictated by state statutes and not a plan document. This section addresses plan investment-related issues specific to GASB Statement No. 67. Chapter 5 of this guide addresses other more general investment considerations.

Relevant Assertions

13.67 The relevant assertions for plan investments and investment income include the following:

- *a.* Investments and investment transactions are initiated in accordance with the established investment policies and comply with plan provisions, laws, and regulations.
- *b.* All investments are recorded and exist.
- *c.* All investments are owned by the plan, free of liens, pledges, and other security interests or, if not free from security interest, it is identified and properly disclosed.
- *d.* All investments are properly valued as of the plan's fiscal year-end.
- *e.* All investment income (including net appreciation or depreciation) is accurately reported.
- *f.* Investment disclosures, including the money-weighted rate of return on plan investments, are complete and accurate.

Examples of Identified Risks of What Can Go Wrong at the Relevant Assertion Level

13.68 The following are examples of identified risks of what can go wrong at the relevant assertion level relating to plan investments and investment income:

- *a.* Investment information from the trustee (custodian) statements do not reconcile to the plan's records (trial balance) or financial statements.
- *b.* Investment manager or subcustodial reports do not reconcile to trustee (custodian) reports.
- *c.* Investment transactions are not recorded by the trustee (custodian) or are not recorded on a timely basis.
- *d.* Investments and investment income (for example, alternative investments, private equity, and real estate) are not properly recorded as of the reporting date due to a lag (for example, 90 days) in reporting information by the investment managers.
- *e.* Investments are not properly reported at fair value due to inappropriate valuation methodologies, mathematical errors in the application of the methodology, or inaccurate inputs.
- *f.* Investment purchase and sale transactions are not properly authorized prior to initiation or are not in accordance with the investment policies, plan provisions, laws, and regulations.
- *g.* Amounts due to (or due from) brokers for securities purchased or sold are not properly recorded.

h. Gains and losses on sales of investments are calculated incorrectly.

i. Allocated insurance contracts are not properly excluded from pension plan assets based upon contract terms.

j. The annual money-weighted rate of return is not properly calculated or disclosed.

Example Audit Procedures to Consider

13.69 General audit procedures for investments and investment income can be found in chapter 5 of this guide.

Contributions and Contributions Receivable

13.70 In addition to the requirements and considerations discussed in chapter 4 related to the auditor's risk assessment and understanding the entity, considerations specific to contributions may include obtaining an understanding of the types of contributions legally required to be remitted to the plan and the eligibility requirements, if applicable. Often, in governmental plans, the plan's contribution provisions are dictated by state statutes and not a plan document.

Relevant Assertions

13.71 The relevant assertions for contributions and contributions receivable are as follows:

a. Amounts received or due the plan for employer (including those from a nonemployer contributing entity) and member contributions have been appropriately calculated, recorded, and disclosed in the financial statements in the proper period, in accordance with the plan provisions.

b. Amounts received or due the plan consist only of contributions pursuant to legal requirements and are recognized in full in the period the receivable arises.

c. Receivables arising from installment contracts are properly recorded in full in the period the receivable arises. If the receivable is recognized at its discounted present value, interest is properly accrued using the effective interest method.

d. Appropriate allowance has been made for uncollectible contributions receivable, if applicable.

Additional Considerations for Cost-Sharing Plans

e. Member census data, including payroll information, used in determining employer and member contributions is complete and accurate.

f. Receivables due from withdrawing employers in a cost-sharing plan have been accurately calculated and reported in the proper period.

Additional Considerations for Agent Plans

g. Employer (including nonemployer contributing entity) and member contributions are recorded in the appropriate employer's separate account.

Examples of Identified Risks of What Can Go Wrong at the Relevant Assertion Level

13.72 The following are examples of identified risks of what can go wrong at the relevant assertion level relating to contributions and contributions receivable:

a. Contributions are not recorded in the proper period (that is, when legally due).

b. Receivables arising from installment contracts are not properly recorded in full when the receivable arises. If a receivable is recognized at its discounted present value, interest is not properly accrued using the effective interest method.

c. Contributions receivable include amounts that are not due pursuant to legal requirements.

d. An appropriate allowance has not been made for uncollectible contributions.

Additional Considerations for Cost-Sharing Plans

e. Census data used in determining employer and member contributions is inaccurate or incomplete, resulting in improper shifting of costs among employers.

f. Employer contributions are not properly calculated based on the contractually required rate.

g. Amounts owed to the plan by employers who have withdrawn from the plan are incorrectly calculated.

Additional Considerations for Agent Plans

h. Employer (including nonemployer contributing entity) and employee contributions are recorded in the wrong employer separate account.

Example Audit Procedures to Consider

Emphasis Point
As discussed in chapter 6, "Revenues and Receivables," of this guide, it is usually more efficient and effective to integrate the auditing of contributions with contributions receivable.

13.73 The following are examples of substantive procedures for auditing contributions and related contributions receivable for the plan:

a. Obtaining a subsidiary ledger (schedule) for contributions and reconciling to the general ledger of the plan.

b. Performing substantive analytical procedures on contributions disaggregated by type of contribution (for example, employers, nonemployer contributing entity, and members), as well as by individual employer.

Emphasis Point

When performing substantive analytical procedures, the auditor should follow the requirements in AU-C section 520, *Analytical Procedures* (AICPA, *Professional Standards*), to evaluate the reliability of data from which the expectation of recorded amounts or ratios is developed, taking into account the source, comparability, the nature and relevance of information available, and controls over the preparation. The auditor should also develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise, when combined, if applicable, with audit evidence from other audit procedures to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.

c. Confirming employer and member contributions with the employer.

d. Confirming nonemployer contributing entity contributions with the nonemployer contributing entity, if applicable.

e. Selecting a sample of employer (including nonemployer contributing entity, if applicable) and member contributions and recalculating the contributions based on the required contribution rate or amount and tracing to cash received.

Emphasis Point

The remittance of periodic contributions from employers is often accompanied by an employer (payroll) transmission report, which includes a detailed listing of pensionable wages and related contributions of active members for each employer. These reports may be used as the basis for tracing contributions to cash received, as well as recalculating contributions for a sample of active members based on required contribution rates.

f. Reviewing criteria used by the plan in accruing employer (including nonemployer contributing entity, if applicable) and member contributions receivable and determining that all legally enforceable accruals have been recorded.

g. Evaluating whether accruals for long-term receivables are in accordance with the installment contract. If the receivable is recognized at discounted present value, determine that interest was accrued using the effective interest method, unless use of the straight-line method would not produce significantly different results.

h. Tracing the subsequent receipt of contributions receivable to supporting documentation.

i. Evaluating the reasonableness of the plan's allowance for estimated uncollectible amounts, if applicable, based on testing collections subsequent to the date of the financial statements and reviewing the status of unpaid amounts.

Additional Considerations for Single-Employer Plans

13.74 In lieu of confirming contributions with the employer, consider tracing employer and member contributions to the employer's payroll records.

Additional Considerations for Cost-Sharing Plans

13.75 In addition to the audit procedures discussed in paragraph 13.73*a–i*, the following are additional examples of substantive audit procedures for auditing contributions to address the risk of cost shifting in the plan:

a. Obtaining a list of participating employers and testing its completeness by examining appropriate plan records, for example, a record of contributing employers, pensionable wages, and delinquency records could be obtained from the plan administrator.

b. Obtaining a schedule of contributions received or receivable and agreeing the contributors to the listing of participating employers obtained for completeness.

c. If contributions are based on actuarially determined amounts, testing the census data at employer locations discussed in paragraphs 13.88–.92.

d. For employers who have withdrawn from the plan, recalculating the (termination) receivable based on the terms of the plan provisions or employer contract.

e. Confirming census data directly with employers not selected for testing in accordance with item *c*.

> ***Emphasis Point***
>
> Although confirming census data with participating employers is possible, such a procedure generally will not provide sufficient appropriate audit evidence for completeness and accuracy due to the ability for employers to underreport. Accordingly, tests of the employers' actual records are normally considered to be more appropriate. See paragraphs 13.88–.92 regarding the testing of census data maintained by the employer.

Additional Considerations for Agent Plans

> ***Emphasis Point***
>
> A significant administrative responsibility for agent plans is the proper maintenance of separate accounts for each participating employer. Accordingly, it is important to design substantive audit procedures that appropriately consider whether contributions are credited to the appropriate employer account.
>
> As discussed in the emphasis point after paragraph 13.01 and appendix A of this chapter, the employer auditor needs to obtain audit evidence that the fiduciary net position specific to the employer and included in the employer's financial statements is not materially misstated. Because the pension related elements, including fiduciary net position, are dependent on information maintained by the plan, significant interaction among the plan, participating employers, and their auditors is necessary to corroborate the pension amounts in employer financial statements.
>
> Appendix A presents two options for the plan auditor to provide assurance services on information prepared by the plan related to fiduciary net position to assist participating employers and their auditors. Plan auditors may want to consider the guidance in appendix A when planning the audit of the financial

statements to gain an understanding of the materiality differences in order to effectively coordinate the work performed for both of the engagements.

Although the guidance in these appendixes is integral to the audit of the employer's financial statements, these appendixes are *other auditing publications* and are nonauthoritative.

13.76 In addition to the audit procedures discussed in paragraph 13.73*a–i*, the following are additional examples of substantive audit procedures for auditing contributions for agent plans:

a. Selecting a sample to test that contributions by individual employers have been credited to the appropriate employer's separate account in accordance with the plan document.

b. Selecting a sample to test that contributions from the nonemployer contributing entity, if applicable, have been credited to the appropriate employer's separate account.

Benefit Payments and Benefits Payable

13.77 In addition to the requirements and considerations discussed in chapter 4 related to the auditor's risk assessment and understanding the entity, considerations specific to benefit payments and benefits payable may include obtaining an understanding of the types of benefits offered by the plan, the eligibility requirements, and the methods of calculating the benefits. Often, in governmental plans, the plan's benefit provisions are dictated by state statutes.

Relevant Assertions

13.78 The relevant assertions related to benefit payments and benefits payable include the following:

a. Benefit payments have been calculated and paid in accordance with plan provisions and related documents.

b. Benefit payments are made only to persons entitled to them (that is, payments are not being made to deceased beneficiaries or persons other than eligible members and beneficiaries).

c. Unpaid benefits due under the plan are recorded as liabilities and benefits payable are valid liabilities of the plan.

d. Amounts have been accurately calculated, recorded, and disclosed in the financial statements in the proper period.

e. Member census data, including payroll and personnel records, used in determining benefit payments is complete and accurate.

Additional Considerations for Agent Plans

f. Benefit payments to members have been made from the appropriate employer's separate account.

Examples of Identified Risks of What Can Go Wrong at the Relevant Assertion Level

13.79 The following are examples of identified risks of what can go wrong at the relevant assertion level relating to benefit payments:

a. Benefit payment calculations are incorrect due to inaccurate or incomplete census data.

b. Benefit payments are incorrectly calculated or not in accordance with the member's benefit election.

c. Benefit payments are not in accordance with the provisions of the plan document.

d. Benefit payments are made to a member or beneficiary who is not eligible to receive benefits.

e. Changes to the payroll or personnel data (including new hires, terminations, and compensation changes) are not authorized, properly recorded, or processed accurately.

f. Benefits payable to members are not properly calculated or accrued in the proper period.

Emphasis Point

It is important for the plan auditor to assess whether there is a fraud risk associated with benefit payments depending on the specific facts and circumstances of internal controls relative to financial reporting or misappropriation of assets. Benefit payments may be susceptible to fraud, especially when there is a lack of segregation of duties—making it possible for an employee to divert unauthorized benefit payments to another account outside the plan. An employee may have the ability to initiate, authorize, and record or change a transaction or may have custody of assets within the process such that he or she is able to perpetrate and conceal a fraud, causing duplicate, excess or fictitious benefit payments, or withdrawals to be recorded. If the auditor concludes that a fraud risk could exist, the auditor is required to design the nature, timing, and extent of audit procedures in response to that risk.

Additional Considerations for Agent Plans

g. The member's benefit payment is made from the wrong employer's separate account.

Example Audit Procedures to Consider

13.80 As discussed in chapter 8, "Expenses or Expenditures and Liabilities," of this guide, because expense-expenditure and liability transactions are closely related, many audit procedures satisfy the objectives of both types of accounts at the same time. The following are examples of substantive procedures for auditing benefit payments and benefits payable:

a. Obtaining a subsidiary ledger (schedule) of all benefit payments (for example, benefits paid to members and purchase of allocated annuity contracts) by type made to plan members for the current plan year and reconciling to the general ledger of the plan.

Emphasis Point

Due to the different risks associated with the various types of payments, segregating the schedule of benefit payments in various ways (for example, by type, by newly retired in the current year from existing retirees as well as by employee class) allows the auditor to select appropriate samples for members receiving benefit payments.

b. Performing substantive analytical procedures on benefit payments disaggregated by type, such as recurring (annuity) payments, lump-sum payments, and death and disability benefits. The plan provisions and census data may serve as a basis for developing expectations.

> ***Emphasis Point***
>
> When performing substantive analytical procedures, the auditor should follow the requirements in AU-C section 520 to evaluate the reliability of data from which the expectation of recorded amounts or ratios is developed, taking into account the source, comparability, and the nature and relevance of information available, as well as controls over the preparation. The auditor should also develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise, when combined, if applicable, with audit evidence from other audit procedures to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.

Recurring (Annuity) Payments

c. Selecting a sample of new annuitants from the schedule of benefit payments and performing the following procedures:

i. Determining whether the member or beneficiary was eligible to receive the distribution in accordance with the plan document (for example, whether the payee meets the eligibility requirements per the plan document).

> ***Emphasis Point***
>
> In evaluating eligibility, consider examining evidence of age and employment history data; comparing employment dates, credited service (taking into consideration interrupted service or service with multiple employers within the plan), earnings, and plan member contributions with appropriate plan records; and examining the benefit election form and dependent designation to determine appropriateness of payment, including the form of distribution, and spousal consent, if applicable, based on the terms of the plan document.

ii. Recalculating the benefit payment, taking into account the amount based on the plan document and related options.

> ***Emphasis Point***
>
> In addition to census data, the benefit payment computation may require the use of such inputs as interest rate tables, Social Security indexes, provisions grandfathered from prior plans, provisions from union contracts, and other inputs as required by the plan provisions or actuarial method. It is important to consider involving an actuary to assist in the testing of the inputs that include actuarial tables and indexes.

iii. Evaluating whether benefit calculations and payments were authorized as required under the plan.

iv. If the benefit is in the form of an annuity that has been purchased through an insurance contract (allocated contract), evaluating whether the annuity contract has been properly calculated and is consistent with the terms of the plan.

v. Verifying payment to the member or beneficiary.

Emphasis Point

Verifying payment to members or beneficiaries can be accomplished in a number of ways, such as confirming payment of benefits, comparing canceled checks with the plan's cash disbursement records (including review of the endorsement), or comparing the payee name or account name on electronic funds transfers with the member or beneficiary name. In addition, the auditor may want to consider inquiring about the existence and frequency of member complaints. Long-outstanding checks may be indicative of duplicate payments or deceased or missing members or beneficiaries.

vi. Agreeing the name, type of benefit, and amount to a member data list to determine that the member or beneficiary was properly classified in the retired category by the actuary. In the case of the purchase of an allocated insurance contract, verifying the member or beneficiary was properly removed from the census data.

Emphasis Point

As discussed in paragraph 13.52, the substantive procedures over census data are ordinarily based on a concept that focuses on testing incremental changes (see paragraph 13.15) to the census data file during the 12-month period immediately preceding the actuarial valuation date when valuations are done annually. These procedures would ordinarily cover the census data reported to the plan during (1) the year immediately preceding the actuarial valuation when the actuarial valuation is performed on an annual basis, or (2) the two-year period immediately preceding the actuarial valuation when the actuarial valuation is performed on a biennial basis. For example, if a plan has a fiscal year-end of June 30, 20X5, and uses a beginning-of-the-year actuarial valuation of July 1, 20X4 (which is rolled forward to the plan's fiscal year-end of June 30, 20X5), the focus of the procedures would ordinarily be over the census data reported to the plan during the year ended June 30, 20X4. In this example, it would not be possible to trace the relevant census data from the sample used to test current-year benefit payments in the previous procedure to the census data file because the reporting periods are different. In this circumstance, the auditor may consider tracing the sample from the prior-year testing of benefit payments to the census data file used to measure the net pension liability for the current year.

If the plan performs biennial valuations, the census data to be tested for the 20X6 valuation would be that reported to the plan since the last valuation (that is, 24-months ending July 1, 20X6).

In contrast, if the plan uses an end-of-the-year valuation to measure the net pension liability as of June 30, 20X5, the auditor would be able to trace the relevant census data from the sample used to test current-year benefit payment to the census data file.

d. Selecting a sample of existing annuitants from the schedule of benefit payments and performing the following procedures:

i. Comparing the current-year payment amount to the prior year and recalculating current-year amount based on the prior-year amount multiplied by the COLA, if applicable.

ii. Verifying payment to the member or beneficiary. See the emphasis point after item *c*(v).

iii. Considering whether payments continue to be appropriate.

Emphasis Point

Based on the auditor's assessment of risks related to the improper payment of benefits (for example, when payments are made to members or beneficiaries over an extended number of years), the auditor may consider performing procedures to revalidate whether beneficiaries continue to be eligible to receive benefits based on the plan provisions. Plans typically perform a cross-match of annuitants with the Social Security Administration death records at least annually to help verify that payments are not made on behalf of deceased members.

iv. Determining that the retiree (or beneficiary, if applicable) is not deceased based on a cross-match of Social Security numbers.

v. Tracing the names, type of benefit, and amount to member data list to determine that the beneficiary was properly classified in the retired category by the actuary.

e. For ad hoc COLAs, verifying whether the COLA was authorized as required under the plan.

Lump-Sum Payments (Distributions)

f. Selecting a sample of lump-sum benefit payments and performing the following procedures:

i. Evaluating whether the member or beneficiary was eligible to receive the lump-sum distribution in accordance with the plan document. See the emphasis point after item *c*(i).

ii. Recalculating the benefit payment, taking into account the amount based on the plan document and related options. See the emphasis point after item *c*(ii).

iii. Evaluating whether the benefit calculation and payment was authorized as required under the plan.

iv. Verifying payment to the member or beneficiary. See the emphasis point after item *c*(v).

v. Examining the member data list to determine the member's or beneficiary's name was properly removed from the census data.

Death, Disability, and Related Benefits

g. Selecting a sample of death and disability payments and performing the following procedures:

i. Examining a copy of the death certificate and beneficiary form, physician's statement, or other appropriate documents.

ii. Verifying payment to the beneficiary. See the emphasis point after item *c*(v).

iii. For death benefits, examining the member data list to determine that the member's or beneficiary's name was properly removed from the census data.

Disbursements by Third Party

h. In some circumstances, benefit disbursements are made by a third party, such as a bank, an insurance company, or other service provider. In these circumstances, the auditor may need to obtain an understanding of the processes and controls at the third party. This can be satisfied through either obtaining and evaluating a type 2 SOC 1 report or applying appropriate auditing procedures at the service organization. Although a type 2 SOC 1 report may be used to reduce substantive procedures, the report is not designed to provide a basis for assessing control risk sufficiently low to eliminate the need for performing any substantive tests.

Additional Considerations for Agent Plans

Emphasis Point

A significant administrative responsibility for agent plans is the proper maintenance of separate accounts for each participating employer. Accordingly, it is important to design substantive audit procedures that appropriately consider whether benefits are made from the appropriate employer account.

Appendix A presents two options for the plan auditor to provide assurance services on information prepared by the plan related to fiduciary net position to assist participating employers and their auditors. Plan auditors may want to consider the guidance in appendix A when planning the audit of the financial statements to gain an understanding of the materiality differences in order to effectively coordinate the work performed for both of the engagements.

Although the guidance in these appendixes is integral to the audit of the employer's financial statements, these appendixes are *other auditing publications* and are nonauthoritative.

i. Selecting a sample of benefit payments to test that the benefit payment has been recorded as a disbursement from the appropriate employer's separate account.

Investment and Administrative Expenses and Related Liabilities

Relevant Assertions

13.81 The relevant assertions for investment and administrative expenses and related liabilities include the following:

a. Investment management and performance fees and administrative expenses have been accurately calculated and reported in the financial statements in the proper period.

b. Reported liabilities represent amounts unpaid and due as of the fiscal year-end.

c. Amounts payable are valid liabilities of the plan.

Examples of Identified Risks of What Can Go Wrong at the Relevant Assertion Level

13.82 The following are examples of identified risks of what can go wrong at the relevant assertion level relating to investment and administrative expenses and related liabilities:

a. Unpaid administrative fees (for example, for actuaries, auditors, trustees, or legal counsel) are incomplete, invalid, or not accurately calculated and reported in the proper period.

b. Investment management and performance fees are incomplete, invalid, or not appropriately calculated and reported in the proper period.

c. Investment and administrative expenses are not properly classified in the statement of changes in fiduciary net position.

Example Audit Procedures to Consider

13.83 Chapter 8 of this guide provides auditing considerations related to liabilities and expenses. However, specific to pension plans, the following are examples of substantive procedures for auditing investment and administrative expenses and related liabilities:

a. Performing substantive analytical procedures on recurring types of administrative expenses.

> ***Emphasis Point***
>
> When performing substantive analytical procedures, the auditor should follow the requirements in AU-C section 520 to evaluate the reliability of data from which the expectation of recorded amounts or ratios is developed, taking into account the source, comparability, the nature and relevance of information available, and controls over the preparation. The auditor should also develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise, when combined, if applicable, with audit evidence from other audit procedures to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.

b. Selecting a sample of investment managers and recalculating the (base) investment management fee and the performance (incentive) fee based on the investment agreement, as well as determining whether the appropriate amount was accrued as of year-end.

> ***Emphasis Point***
>
> The calculation of a performance (incentive) fee is specific to the terms of the investment agreement, but generally, the calculation should be as if the

investment assets and related liabilities are liquidated at their fair value as of the date of the statement of fiduciary net position.

c. Evaluating whether investment and administrative expenses are properly classified in the statement of changes in fiduciary net position.

Emphasis Point

As required by paragraph 26 of GASB Statement No. 67, all investment-related costs should be reported as investment expense if they are separate from (*a*) investment income and (*b*) the administrative expenses of the plan. This includes investment management and custodial fees and all other significant investment-related costs, such as the allocable share of salary and fringe benefits for employees that spend a significant portion of time on tasks related to investments.

Total Pension Liability, Net Pension Liability, and Related Disclosures for Single-Employer and Cost-Sharing Plans

13.84 In addition to the requirements and considerations discussed in chapter 4 related to the auditor's risk assessment and understanding the entity, considerations specific to total pension liability, net pension liability, and related disclosures may include obtaining an understanding of the actuary's objectives, scope of work, methods and assumptions, and consistency of application.

Relevant Assertions

13.85 The relevant assertions related to the total pension liability, net pension liability, and related disclosures for single-employer and cost-sharing plans include the following:

a. Member census data used in calculating the actuarially computed total pension liability is complete and accurate.

b. Actuarial assumptions in computing the total pension liability are in accordance with GASB Statement No. 67 requirements and the Actuarial Standards of Practice issued by the Actuarial Standards Board.

c. The total pension liability, fiduciary net position, and net pension liability have been properly calculated and disclosed in accordance with GASB Statement No. 67 requirements.

Examples of Identified Risks of What Can Go Wrong at the Relevant Assertion Level

13.86 The following are examples of identified risks of what can go wrong at the relevant assertion level relating to total pension liability, net pension liability, and related disclosures for single-employer and cost-sharing plans:

a. The actuary does not have the appropriate qualifications or related experience to perform the valuation.

b. Members (or member groups in a cost-sharing plan) are inappropriately excluded from or included in the census data.

c. Census data reported to the plan by the participating employer(s) does not reconcile to (agree with) the employer's payroll and personnel records, causing errors in the computation of total pension liability.

d. The plan does not properly accumulate (maintain) the census data based on information reported by the employer(s) for active members as well as activity for census data controlled by the plan for inactive members, causing errors in the computation of total pension liability.

e. The plan's actuary uses incomplete (missing) or incorrect census data causing errors in the computation of total pension liability.

f. The plan's actuary uses inappropriate assumptions or actuarial methods that are not in conformity with GASB Statement No. 67 and the Actuarial Standards of Practice causing errors in the computation of total pension liability. Examples of inappropriate assumptions or actuarial methods include the following:

   i. Using an actuarial cost method other than entry age normal for computing the total pension liability.

   ii. Using a long-term rate of return that does not reflect the future expected rate of return on plan investments based on investment strategy and target asset allocations.

   iii. Using inappropriate cash flow projections when calculating the discount rate.

   iv. Using mortality assumptions that do not properly reflect expected future improvement in mortality rates.

g. Projected benefit payments used in the actuarial valuation do not include all benefits to be provided to active and inactive members in accordance with the benefit terms that are in force at the plan's fiscal year-end, causing the incorrect computation of the total pension liability.

h. Projected benefit payments used in the actuarial valuation do not include the effects of automatic postemployment benefits, ad hoc benefit changes that are substantively automatic, or projected salary changes, causing the incorrect computation of the total pension liability.

i. Plan amendments or changes in benefit terms have not been properly included or excluded as of the plan's fiscal year-end.

j. The fiduciary net position used in calculating the net pension liability is not the same as the fiduciary net position reported in the plan's statement of fiduciary net position.

Example Audit Procedures to Consider

13.87 The following are examples of substantive procedures for auditing total pension liability, net pension liability, and related disclosures for single-employer and cost-sharing plans:

a. Obtaining the actuarial valuation report used to measure the total pension liability as of the plan's fiscal year-end based on GASB Statement No. 67.

> ***Emphasis Point***
>
> Plans often have different actuarial valuations performed for accounting purposes (for example, GASB Statement No. 67) and funding purposes (for example, actuarially determined contributions). It is important the auditor receive a complete actuarial valuation report that has been prepared for accounting purposes that includes an actuarial certification.

b. Evaluating the professional qualifications of the actuary, including his or her competence, capabilities, and objectivity as required by paragraph .08 of AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*). If the actuary is not known to the auditor, consider other factors that might provide information regarding the actuary's qualifications, such as (i) the actuary's membership in a recognized professional organization, (ii) the number and types of public pension plans served, including years of experience, and (iii) the opinion of other actuaries whom the auditor knows to be qualified regarding the actuary's professional qualifications.

> ***Emphasis Point***
>
> Paragraph .12 of AU-C section 300, *Planning an Audit* (AICPA, *Professional Standards*), states the auditor should consider whether specialized skills are needed in performing an audit. Careful consideration of the engagement team skills, knowledge, and experience as it relates to actuarial information is critical in such engagements. If specialized skills are needed, consider using an auditor specialist (for example, an actuary) in evaluating the appropriateness of the actuarial valuation and the measurement of the total pension liability.

c. Inquiring about the nature of any interests or relationships the actuary may have with the plan or employer(s) that may create threats to the actuary's objectivity (for example, financial interests, business or personal relationships, or the provision of other services) and any applicable safeguards.

> ***Emphasis Point***
>
> Although safeguards cannot eliminate all threats to the objectivity of an actuary, threats such as intimidation by management may be of less significance to a specialist engaged versus employed by the plan or plan administrator. This evaluation of objectivity may be accomplished by the auditor asking management to have the actuary describe in writing interests and relationships, if any, that may exist and that may appear to impair the objectivity of the actuary.

d. Reading the actuarial certification for potential exclusions from the scope of the actuary's work or for qualifications on the actuary's certification relating to actuarial methods, actuarial assumptions, or census data.

e. Inquiring of management and the actuary whether the actuarial valuation considers all pertinent provisions of the plan, including any changes or amendments to the plan or other events affecting the actuarial calculations that are effective as of the plan's fiscal year-end.

f. Determining whether the actuarial valuation was performed as of a date within 24 months of the plan's fiscal year-end.

g. Evaluating whether the methods and assumptions used in determining the total pension liability and actuarially determined contributions information are in accordance with GASB Statement No. 67 and Actuarial Standards of Practice. See examples of identified risks of what can go wrong related to actuarial assumptions in paragraph 13.86*f*.

h. If the actuarial valuation was performed as of a date prior to the plan's fiscal year-end, reviewing the appropriateness of the update procedures to roll forward the total pension liability to the plan's fiscal year-end and determining whether all significant known events have been properly included.

i. Testing the reliability and completeness of the member census data used. See paragraphs 13.88–.93 for specific procedures.

j. Evaluating the propriety of the long-term expected rate of return used in the calculation of the discount rate.

Emphasis Point

Paragraph 44 of GASB Statement No. 67 requires the long-term expected rate of return used in the calculation of the discount rate to be forward-looking and be based on the appropriate expected long-term rate of return considering target asset allocations. It is often developed using a building-block approach based on portfolio modeling. Plan management should evaluate the appropriateness of the rate each year based on current information. When evaluating the reasonableness of management's assumption, the auditor is cautioned to avoid supporting the reasonableness of this assumption solely based on retrospective analysis of historical investment returns.

k. Evaluating whether the discount rate is reasonable and is a single rate in accordance with GASB Statement No. 67.

i. Obtaining the discount rate calculation and supporting schedules as of the plan's fiscal year-end.

ii. Testing the mathematical accuracy of the discount rate calculation and supporting schedules.

iii. Performing the following procedures on the components[13] of the projection of the plan fiduciary net position (that is, net position roll forward):

(1) Tracing beginning plan fiduciary net position to audited plan financial statements.

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[13] Components would include projected beginning fiduciary net position by year, projected contributions for the year, projected benefit payments for the year, projected investment return for the year, projected administrative expenses for the year, and ending fiduciary net position.

(2) Comparing employer (including nonemployer contributing entity, if applicable) and plan member contributions in (future) year one to actual contributions in current year audited plan financial statements.

(3) Evaluating reasonableness of projected future employer (including nonemployer contributing entity, if applicable) and plan member contributions based on age demographics of active plan members. As active plan members retire, projected future contributions will decrease dramatically as employer and plan member contributions related to future employees are excluded.

(4) Evaluating appropriateness of projected future employer (including nonemployer contributing entity, if applicable) contributions based on the criteria in paragraph 42 of GASB Statement No. 67.

Emphasis Point

As discussed in paragraphs 42–43 of GASB Statement No. 67, plan management should apply professional judgment to project cash flows for contributions from the employers and nonemployer contributing entities in circumstances in which (*a*) those contribution amounts are established by statute or contract, or (*b*) a formal, written policy related to those contributions exists. Plan management's application of professional judgment should consider the most recent five-year contribution history (to determine the degree of adherence to preceding [*a*] and [*b*]) of the employers and nonemployer contributing entities as a key indicator of future contributions from those sources and should reflect all other known events and conditions.

In circumstances in which there is a statute or formal written policy that requires increasing contribution rates in future years, plan management's application of professional judgment will likely be difficult in determining whether to consider such funding in projected cash flows for contributions. Further, in evaluating the appropriateness of plan management's judgment about future contributions, the auditor considers the most recent five-year history and evaluate the likelihood that the increased contribution rates will be made. In evaluating the likelihood that increased contributions will be made, the auditor may consider whether the government has a history of amending similar statutes and written policies due to inability to make the required contributions.

In circumstances other than those described in (*a*) and (*b*), the amount of projected cash flows for contributions from employers and nonemployer contributing entities should be limited to an average of contributions from those sources over the most recent five-year period (percentage of covered payroll contributed or percentage of actuarially determined contributions made) and may be modified based on consideration of subsequent events.

(5) Comparing (future) year-one benefit payments to actual benefit payments in the current year audited plan financial statements.

(6) Evaluating reasonableness of projected future benefit payments based on age demographics of current plan members, projected retirement dates, projected benefit payments based on the applicable benefit formula, and mortality assumptions used in the actuarial valuation.

(7) Recalculating investment earnings by year based on the long-term expected rate of return.

iv. Performing the following on the calculation of actuarial present values of the projected benefit payments:

(1) Tracing beginning fiduciary net position for each year presented and projected benefit payments to net position roll forward tested previously.

(2) For future years in which beginning fiduciary net position is sufficient to pay projected benefits for the respective year, determining whether the projected benefit payments were properly discounted using the long-term expected rate of return on plan investments.

(3) For future years in which beginning fiduciary net position is not sufficient to pay projected benefits for the respective year, determining whether the projected benefit payments were properly discounted using an appropriate 20-year AA municipal bond yield or index rate as of the plan fiscal year-end.

(4) Recalculating the single (blended) discount rate.

l. Verifying the fiduciary net position used in calculating the net pension liability is the same as the fiduciary net position reported in the plan's statement of fiduciary net position.

m. Recomputing the calculation for the *net pension liability*, which is the total pension liability less the plan fiduciary net position as of the plan's fiscal year-end.

Census Data

13.88 In addition to the requirements and considerations discussed in chapter 4 related to the auditor's risk assessment and understanding the entity, considerations specific to census data may include obtaining an understanding of the following:

a. Assumptions used by the actuary in changing census data, if applicable.

b. Plan's processes and controls used by management to accurately and completely maintain records for significant elements of census data for all plan members (active, inactive members entitled to but not yet receiving benefits, and inactive currently receiving benefits).

c. Plan's processes and controls used by the plan's management to accumulate census data reported by the employers, including enrollment, status changes, and employer (payroll) transmission reports.

Emphasis Point

The processes for accumulating census data reported by employers for many plans are highly automated with little or no manual intervention. Accordingly, the auditor may determine that it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive audit procedures. In such cases, the plan's controls over such risks are relevant to the audit, thus, the auditor should obtain an understanding of the controls and consider testing the operating effectiveness.

d. For the employer in the single-employer plan or the employers selected to test in a cost-sharing plan (discussed in paragraphs 13.53–.58):

i. Employers' processes for enrolling new employees and reporting status changes to the plan.

ii. Employers' payroll accounting systems and systems of reporting information included in the employer (payroll) transmission reports submitted to the plan.

13.89 The procedures in the following paragraphs are designed to address the completeness and accuracy of census data. Census data supports various assertions and identified risks of what can go wrong related to numerous financial statement elements of defined benefit pension plan financial statements. The specific assertions and examples of identified risks of what can go wrong are included in the relevant elements previously discussed. The following table highlights where census data is discussed in the preceding sections.

	Single	***Cost-Sharing***	***Agent***
Contributions and Contributions Receivable			
Assertions	—	13.71*e*	—
Identified risks of what can go wrong	—	13.72*e*	—
Benefit Payments			
Assertions	13.78*e*	13.78*e*	13.78*e*
Identified risks of what can go wrong	13.79*a*	13.79*a*	13.79*a*
Total Pension Liability, Net Pension Liability, and Related Disclosures			
Assertions	13.85*a*	13.85*a*	—
Identified risks of what can go wrong	13.86*c* 13.86*d* 13.86*e*	13.86*c* 13.86*d* 13.86*e*	—

Example Audit Procedures to Consider for Single-Employer and Cost-Sharing Plans

13.90 The following section provides examples of substantive procedures for auditing the completeness and accuracy of census data related to single-employer and cost-sharing plans when the plan and participating employer(s) have different governance structures. The procedures have been separated into two different sections: (1) procedures to be performed at the employer locations to test the underlying payroll and personnel records and (2) procedures to be performed at the plan level. These procedures are designed to provide audit evidence to support the relevant assertions that are affected by census data, including those related to contributions, contributions receivable, benefit payments, and total pension liability.

13.91 In circumstances when the plan and employer have the same governance structure, there often will not be a formal reporting process of census data from the plan to the employer (that is, employer [payroll] transmission reports). In these circumstances, the procedures will need to be modified accordingly.

Emphasis Point

As discussed in paragraph 13.52, the substantive procedures over census data are ordinarily based on a concept that focuses on testing incremental changes (see paragraph 13.15) to the census data file during the 12-month period immediately preceding the actuarial valuation date when valuations are done annually.These procedures would ordinarily cover the census data reported to the plan during (1) the year immediately preceding the actuarial valuation when the actuarial valuation is performed on an annual basis, or (2) the two-year period immediately preceding the actuarial valuation when the actuarial valuation is performed on a biennial basis. For example, if a plan has a fiscal year-end of June 30, 20X6, and uses a beginning of the year actuarial valuation of July 1, 20X5 (which is rolled forward to the plan's fiscal year-end of June 30, 20X6), the focus of the procedures would ordinarily be over the census data reported to the plan during the year ended June 30, 20X5. Additionally, the procedures should cover the entire year and not be limited to a specific point in time during the year.

If the plan performs biennial valuations, the census data to be tested for the 20X6 valuation would be that reported to the plan since the last valuation (for example, 24-months ending July 1, 20X6).

In this example, the substantive procedures over census data would directly correlate with the actuarial valuation used to measure the pension liability as of the plan's year-end. However, the census data tested would not correlate directly with the period for contributions and benefit payments recognized in the current year (that is, the year ended June 30, 20X6). Assuming the auditor believes there is no significant risk of material misstatement due to incomplete or inaccurate census data, the auditor would not ordinarily be expected to test census data reported to the plan during the year ended June 30, 20X6, to support the relevant financial statement assertions related to contributions and benefit payments. Rather, the auditor likely could obtain sufficient audit evidence through analytical procedures.

Example Procedures Performed at Employer for Census Data of Active Members of Single-Employer and Cost-Sharing Plans

> ***Emphasis Point***
>
> For cost-sharing plans, the audit procedures performed by the plan auditor include selecting a representative group of participating employers each year on a rotating basis for testing underlying payroll and personnel records (at the employer location) of employees who are potentially eligible for participation in the cost-sharing plan (see paragraphs 13.53–.58). The purpose of this is to obtain sufficient appropriate evidence that the census data reported to the actuary is complete and accurate.
>
> For single-employer plans, audit procedures to test the underlying employer payroll and personnel records would ordinarily be performed each year to obtain sufficient appropriate evidence that the census data reported to the actuary is complete and accurate.

13.92 For the employer in the single-employer plan or the employers selected to test in a cost-sharing plan (discussed in paragraphs 13.53–.58), the following are example procedures to be performed at the employer locations to test the underlying payroll and personnel records:

- *a.* Identifying the payroll registers and payroll cycles for all reporting units of the government.
- *b.* Obtaining the population of employer (payroll) transmission reports submitted to the plan since the previous valuation and performing the following:
  - i. Evaluating whether the population of employer (payroll) transmission reports received is complete based on an understanding of the employer's payroll registers and cycles.
  - ii. Selecting a sample of employer (payroll) transmission reports to verify the mathematical accuracy of reports and whether the correct contribution rates were used.
- *c.* Obtaining a list of new employees hired during the period from the prior valuation to the current valuation from the employer and performing the following procedures:
  - i. Selecting a sample to determine that eligible new employees were appropriately enrolled in the plan and properly included in the employer (payroll) transmission reports.
  - ii. For each employee selected, verifying the significant elements of census data reported to the plan upon enrollment to the payroll and personnel records (for example, name, Social Security number, date of birth, gender, date of hire, marital status, and position or job code).

> ***Emphasis Point***
>
> If this procedure is performed by the employer auditor, the auditor will likely need to obtain the enrollment forms or the equivalent information from the plan.

d. Obtaining a list of status changes reported to the plan during the period from the prior valuation to the current valuation (other than those reported through the employer [payroll] transmission reports) and selecting a sample to determine that they were appropriate based on the relevant plan criteria and underlying payroll and personnel records.

e. Selecting a sample of active members and performing the following procedures:

> ***Emphasis Point***
>
> Consider selecting a sample from the employer's payroll registers throughout the year and a sample from the employer (payroll) transmission reports throughout the year.

i. Agreeing details included in the applicable employer (payroll) transmission report (for example, name, position or job code, periods of time worked, pensionable wages for the period, employer contribution for the period, and employee contribution for the period) to the payroll register (or vice versa), and agree the underlying information to the payroll and personnel records.

ii. Evaluating whether the selected employee is eligible to participate in the plan based on the eligibility criteria included in the plan document (state statutes).

iii. Recalculating service credits.

Example Procedures Performed at the Plan Level Related to the Accumulation of Information Reported by the Employer(s) and the Completeness and Accuracy of the Census Data File

13.93 The following are example procedures to be performed at the plan level.

a. Reviewing the actuarial certification (in the actuarial valuation report) to determine whether there were any exceptions identified related to the census data and testing resolution as necessary.

b. Obtaining the census data file sent to the actuary from either the actuary or the plan. If obtained from the plan, obtaining evidence that information obtained from the plan was the same information reported to and used by the actuary (for example, obtaining a written confirmation from the actuary).

c. Confirming with the actuary whether there was any missing information or changes made to the census data file provided by plan management.

d. Evaluating the potential impact of assumptions used by the actuary in changing census data (for example, corrections to address missing data) on the total pension liability.

e. Obtaining and testing a reconciliation of aggregate census data from plan records to the census data file and the actuarial valuation report (for example, the number of members and pensionable wages reported in the census data file to amounts shown in the actuarial valuation report).

f. Obtaining and testing a roll forward of the census data from the prior valuation to the current valuation, including testing significant reconciling items.

g. Comparing the number of plan members for the current year versus the prior year, as well as the number of plan members versus the number of employees. Consider disaggregating the analysis in various ways, (for example, by employer, age of employee, and status [active, inactive employees entitled to but not yet receiving benefits, or inactive employees or their beneficiaries receiving benefits]).

h. Selecting a sample of new employees during the period from the prior valuation to the current valuation from the employee enrollments and determining whether they are properly included in the current census data file.

i. Selecting a sample of active members and performing the following procedures:

> ***Emphasis Point***
>
> Consider selecting a sample from the employer (payroll) transmission reports and a sample from the census data file.

i. Evaluating whether the employee is eligible to participate in the plan based on information included in the census data file and criteria included in the plan document.

ii. Comparing the static census data (for example, name, date of birth, date of hire, gender, and spouse's date of birth) in the current census data file to the prior census data file.

iii. For significant elements of census data that change based on current-year events and activity (for example, service credits, pensionable wages, and marital status), verifying or recalculating the census data in the current census data file based on the prior census data file and the incremental changes reported during the period from the prior valuation to the current valuation through the employer (payroll) transmission reports and other status changes reported by the employer.

j. Selecting a sample of inactive members entitled to but not yet receiving benefits and comparing the census data information from the current census data file to the prior census data file (or vice versa).

> ***Emphasis Point***
>
> Consider selecting a sample of inactive members entitled to but not yet receiving benefits from the current census data file and a sample from the prior census data file.

k. Selecting a sample of inactive members currently receiving benefits and performing the following procedures:

> ***Emphasis Point***
>
> Consider selecting a sample of inactive members entitled to but not yet receiving benefits from the current census data file and a sample from the prior census data file.

i. Comparing the static census data information from the current census data file to the prior census data file.

ii. Verifying or recalculating the significant elements of census data that change based on criteria in the plan document (for example, verifying the retirement benefit by comparing the benefit payment in the prior census data file and recalculating the current benefit payment based on the COLA for the current year).

iii. Comparing the benefit payments included in the census data file to the general ledger detail.

iv. Determining that the retiree (or beneficiary, if applicable) is not deceased based on a cross-match of Social Security numbers.

Example Audit Procedures to Consider for Agent Plans

13.94 As discussed in paragraph 13.64, financial statements of agent plans do not reflect any liabilities, deferred outflows of resources, deferred inflows of resources, or expenses that are based on actuarial information. Accordingly, the auditors of agent plans generally do not need to test census data at participating employers.

13.95 The focus of the procedures performed is on the accumulation and maintenance of census data by the plan based on its role as the record keeper. Accordingly, the auditor generally performs procedures similar to those performed at the plan level for cost-sharing plans in procedures previously mentioned in paragraph 13.93. The audit procedures should be designed to provide audit evidence to support relevant assertions related to benefit payments. These procedures are designed to provide audit evidence to support benefit payments affected by census data.

Part II—Employer Accounting, Financial Reporting, and Auditing Considerations: Single and Agent Employers

> ***Emphasis Point***
>
> Part II of this chapter addresses specific accounting and auditing considerations for employers participating in single-employer and agent multiple-employer defined benefit pension plans in accordance with GASB Statement No. 68. Part II makes reference to suggested solutions to multiple-employer plans discussed in appendixes A–B. Although the guidance in these appendixes is integral to the audit of the employer's financial statements, these appendixes are *other auditing publications* and are nonauthoritative.

Part II of this chapter also addresses plans not administered through a qualifying trust under GASB Statement No. 73. However, because of the similarities between GASB Statement No. 68 and GASB Statement No. 73, part II of this chapter only specifically addresses GASB Statement No. 73 requirements and related auditor guidance that differ from GASB Statement No. 68. Those differences are called out in boxes titled "Considerations for Pensions Not Administered Through a Qualifying Trust." Otherwise the guidance in part II should be considered for plans not administered through a qualifying trust.

Accounting and Financial Reporting Considerations

Recognition and Measurement in Financial Statements Prepared Using Economic Resources Measurement Focus and Accrual Basis of Accounting (No Special Funding Situation)

13.96 Governments (employers) that provide defined benefit pensions through a single-employer plan or agent multiple-employer (agent) plan that is administered through a qualifying trust are required to recognize net pension liability, pension expense, and certain deferred outflows of resources and deferred inflows of resources (pension amounts) in their financial statements in accordance with GASB Statement No. 68.

Considerations for Pensions Not Administered Through a Qualifying Trust

Throughout this section, consider the following differences in terminology to adapt the guidance to pensions not administered through a qualifying trust:

- ***Net Pension Liability:*** Replace instances where *net pension liability* is used with *total pension liability* as such pensions have no assets in a qualifying trust, therefore no fiduciary net position to consider.
- ***Fiduciary Net Position:*** This term is not relevant to such pensions.
- ***Plan:*** In many instances, there is guidance and emphasis points related to information obtained from and coordination with the plan. When a pension is not administered through a qualifying trust, the plan is typically administered under the governance of the employer. As a result, there may not be a substantive distinction between the entity that administers the plan and the employer.
- ***Contributions:*** Replace instances where *contributions* is used in the following with *amounts paid by the employer for pensions as the benefits come due*.

Net Pension Liability

13.97 Paragraph 20 of GASB Statement No. 68 requires that the net pension liability[14] be measured as the portion of the actuarial present value of

[14] In this guide, references to *net pension liability* also apply to the situation in which the pension plan's fiduciary net position exceeds the total pension liability, resulting in a net pension asset. For benefits provided through a single-employer or agent plan in which there is a special funding

(continued)

projected benefit payments that is attributed to past periods of employee service (total pension liability), net of the pension plan's fiduciary net position. The assumptions used in measuring the total pension liability should be the same as those used for the plan as discussed in part I of this chapter. The fiduciary net position component of net pension liability should be determined using the same valuation methods that are used by the pension plan for purposes of preparing its statement of fiduciary net position. The net pension liability should be measured as of a date (measurement date) no earlier than the end of the employer's prior fiscal year, consistently applied from period to period.

Emphasis Point

Based on the need for information from the plan, the employer will likely select a measurement date that coincides with the fiscal year-end of the plan.

Considerations for Pensions Not Administered Through a Qualifying Trust

Paragraph 26 of GASB Statement No. 73 addresses the measurement of total pension liability, which is consistent with GASB Statement No. 68. However, since fiduciary net position is not relevant to such plans, the concept of net pension liability does not exist in pensions not administered through a qualifying trust. Also consistent with GASB Statement No. 68, the total pension liability should be measured as of a date (measurement date) no earlier than the end of the employer's prior fiscal year and no later than the end of the employer's current fiscal year, consistently applied from period to period.

13.98 When the underlying actuarial valuation is as of a date prior to the required measurement date, paragraph 22 of GASB Statement No. 68 requires the use of update procedures to roll forward the valuation to the measurement date for the employer's reporting. The employer may roll forward an actuarial valuation performed as of a date no more than 30 months and 1 day earlier than the employer's most recent fiscal year-end to the employer's measurement date. Professional judgment should be used to determine the specific update procedures to be used. If significant changes occur between the actuarial valuation date and the measurement date, consideration should be given to whether a new actuarial valuation is needed.

Emphasis Point

Employers should work collaboratively with the plan to determine the timing and frequency of actuarial valuations, especially if the plan chooses to perform actuarial valuations on a biennial basis. GASB Statement No. 68 requires the total pension liability for employers be determined by an actuarial valuation performed as of a date no more than 30 months and 1 day from the employer's most recent fiscal year-end. It is possible for a plan to be in compliance with the requirements of GASB Statement No. 67 (for example, actuarial valuation

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(footnote continued)

situation, the net pension liability, measured in conformity with paragraph 20 of GASB Statement No. 68, *Accounting and Financial Reporting for Pensions—an amendment of GASB Statement No. 27*, is referred to as the *collective net pension liability*.

within 24 months of the plan's fiscal year-end), but the date of that valuation could be greater than 30 months and 1 day from the employer's most recent fiscal year-end, which would not be in compliance with the requirements of GASB Statement No. 68.

Pension Expense, Deferred Outflows of Resources, and Deferred Inflows of Resources

13.99 The pension expense, deferred outflows of resources, and deferred inflows of resources related to pensions that are required to be recognized by an employer primarily result from changes in the components of the net pension liability during the measurement period—that is, changes in the total pension liability and the pension plan's fiduciary net position. Most changes in the net pension liability during the measurement period are included in pension expense. For example, changes in the total pension liability during the measurement period resulting from current-period service cost, interest on the total pension liability, and changes of benefit terms are required to be recognized as pension expense in the current reporting period. Projected earnings on the pension plan's investments also are required to be included in the determination of pension expense in the current reporting period. Exhibit 13-4 of this chapter provides a summary of the various components of pension expense.

Considerations for Pensions Not Administered Through a Qualifying Trust

As previously discussed, pensions not administered through a qualifying trust have no assets in a qualifying trust. Therefore, no fiduciary net position or plan investments exist. Instead, pension expense, deferred outflows of resources, and deferred inflows of resources related to pensions that are required to be recognized by an employer primarily result from changes in the total pension liability during the measurement period.

13.100 Specifically, paragraph 33 of GASB Statement No. 68 states that changes in the net pension liability should be recognized in pension expense in the current reporting period except as indicated in the following:

a. Each of the following should be recognized in pension expense, beginning in the current reporting period, using a systematic and rational method over a closed period equal to the average of the expected remaining service lives of all employees that are provided with pensions through the pension plan (active employees and inactive employees) determined as of the beginning of the measurement period:

  i. Differences between expected and actual experience with regard to economic or demographic factors (differences between expected and actual experience) in the measurement of the total pension liability

  ii. Changes of assumptions about future economic or demographic factors or of other inputs (changes of assumptions or other inputs)

The portion of (i) and (ii) not recognized in pension expense should be reported as deferred outflows of resources or deferred inflows of resources related to pensions.

b. The difference between projected and actual earnings on pension plan investments should be recognized in pension expense using a systematic and rational method over a closed five-year period, beginning in the current reporting period. The amount not recognized in pension expense should be reported as deferred outflows of resources or deferred inflows of resources related to pensions. Deferred outflows of resources and deferred inflows of resources arising from differences between projected and actual pension plan investment earnings in different measurement periods should be aggregated and reported as a net deferred outflow of resources related to pensions or a net deferred inflow of resources related to pensions.

Considerations for Pensions Not Administered Through a Qualifying Trust

Paragraph 13.100*b* is not relevant to pensions not administered through a qualifying trust.

In addition to the discussion in paragraph 13.99, paragraph 34 of GASB Statement No. 73 requires pension expense to be recognized in the current period for costs incurred by the employer related to the administration of pensions. The measurement period for these costs should be the same as for the measurement period applied to changes in the total pension liability.

c. Contributions to the pension plan from the employer should not be recognized in pension expense.

d. Contributions to the pension plan from nonemployer contributing entities that are not in a special funding situation should be recognized as revenue by the employer government.

13.101 Paragraph 34 of GASB Statement No. 68, as amended, requires contributions to the pension plan from the employer subsequent to the measurement date of the net pension liability and before the end of the reporting period (excluding amounts associated with the employer from nonemployer contributing entities that are not in a special funding situation) be reported as a deferred outflow of resources related to pensions.

Emphasis Point

GASB *Implementation Guide 2015-1* (GASB IG 2015-1) question 5.143.1 requires that the deferred outflow of resources reported by an employer for contributions made after the measurement date and before the end of the employer's financial reporting period should include contributions made by the employer during its fiscal year that will be reflected in the net pension liability in the next measurement period—that is, the amount of contributions through the end of the employer's fiscal year to be recognized by the pension plan on the accrual basis of accounting in the next measurement period. Additionally, in accordance with GASB Implementation Guide 2016-1 (IG 2016-1) question 4.23, in the subsequent period, such contributions should be accounted for as a reduction of deferred outflows of resources related to pensions and as part of the change in the net pension liability.

Considerations for Pensions Not Administered Through a Qualifying Trust

Paragraph 35 of GASB Statement No. 73 requires reporting a deferred outflow of resources related to pensions for the following transactions made subsequent to the measurement date of the total pension liability and before the end of the reporting period: (*a*) amounts paid by the employer for pensions as the benefits come due and (*b*) amounts incurred by the employer for pension administrative expenses.

Exhibit 13-4: Components of Pension Expense

Components of Pension Expense	***Impact on Pension Expense***
Service cost (before effect of employee contributions)	Increase
Employee contributions	Decrease
Interest on total pension liability	Increase
Changes in benefit terms	Increase or Decrease
Plan administrative costs	Increase
Projected earnings on plan investments	Decrease
Recognition (amortization) of deferred outflows of resources:	
Differences between expected and actual experience	Increase
Changes of assumptions	Increase
Net difference between projected and actual investment earnings(1)	Increase
Changes in proportion(2)	Increase
Differences between actual contributions and proportionate share(2)	Increase
Recognition (amortization) of deferred inflows of resources:	
Differences between expected and actual experience	Decrease
Changes of assumptions	Decrease
Net difference between projected and actual investment earnings(1)	Decrease
Changes in proportion(2)	Decrease
Differences between actual contributions and proportionate share(2)	Decrease

(1) Note that the net difference between projected and actual investment earnings is presented as either a deferred outflow of resources or a deferred inflow of resources at a single point in time.
(2) Deferred outflows of resources and deferred inflows of resources related to changes in proportion and differences between actual contributions and proportionate share of total employer contributions may be applicable to single and agent employers when allocating pension amounts to funds, departments, or component units.

Considerations for Pensions Not Administered Through a Qualifying Trust

The following items are not relevant to pension expense for such pensions: (1) employee contributions; (2) projected earnings on plan investments; and (3) recognition (amortization) of deferred outflows of resources and deferred inflows of resources related to the net difference between projected and actual investment earnings.

When reporting pensions in stand-alone financial statements of primary governments and component units that provide pensions through the same defined benefit pension plan, additional deferred outflows of resources and deferred inflows of resources that result from the following may be relevant:

- Changes in proportion as discussed in paragraph 54 of GASB Statement No. 73
- Differences between the total amounts of payments for pensions as the benefits come due and the amount of the government's proportionate share of the total of such payments from all entities as discussed in paragraph 55 of GASB Statement No. 73

Additionally, pension expense should be recognized for costs incurred by the government related to the administration of pensions and the total of nonemployer contributing entities' expenses for costs incurred related to the administration of pensions associated with the government as discussed in paragraph 56 of GASB Statement No. 73.

Allocation of Pension Amounts to Funds or Departments, or Both

13.102 GASB Statement No. 68 does not establish specific requirements for allocation of the net pension liability or other pension-related amounts to individual funds or departments. However, GASB IG 2015-1 question 5.129.1 states the following:

> For proprietary and fiduciary funds, consideration should be given to National Council on Governmental Accounting (NCGA) Statement 1, *Governmental Accounting and Financial Reporting Principles*, paragraph 42, as amended, which requires that long-term liabilities that are "directly related to, and expected to be paid from" those funds be reported in the statement of net position or statement of fiduciary net position, respectively.

Accordingly, when governments allocate pension amounts to funds or departments, or both, the allocation methodology described for employers participating in cost-sharing plans as discussed in part III of this chapter would be appropriate for such purpose. Such an allocation approach may result in the recognition of additional deferred outflows of resources or deferred inflows of resources related to changes in proportion from year to year.

Recognition and Measurement in Financial Statements Prepared Using Current Financial Resources Measurement Focus and Modified Accrual Basis of Accounting

13.103 In financial statements prepared using the current financial resources measurement focus and modified accrual basis of accounting, paragraph 36 of GASB Statement No. 68 specifies that a net pension liability should be recognized to the extent the liability is normally expected to be liquidated with expendable available financial resources. Pension expenditures should be recognized equal to the total of (*a*) amounts paid by the employer to the pension plan and (*b*) the change between the beginning and ending balances of amounts normally expected to be liquidated with expendable available financial resources. Net pension liabilities are normally expected to be liquidated with expendable available financial resources to the extent that benefit payments have matured—that is, benefit payments are due and payable and the pension plan's fiduciary net position is not sufficient for payment of those benefits.

Considerations for Pensions Not Administered Through a Qualifying Trust

Paragraph 60 of GASB Statement No. 73 specifies that pension expenditures should be recognized equal to the total of (*a*) amounts paid by the employer for pensions as the benefits come due and (*b*) the change between the beginning and ending balances of amounts normally expected to be liquidated with expendable available financial resources. Total pension liabilities are normally expected to be liquidated with expendable available financial resources to the extent that benefit payments have matured—that is, benefit payments are due and payable.

Note Disclosures and Required Supplementary Information

13.104 Paragraphs 37–45 of GASB Statement No. 68 address the note disclosures in the financial statements of single and agent employers. The following are among the required disclosures:

- Plan description
- Changes in net pension liability (including beginning balances of the components of net pension liability, effects during the reporting period of items that change the components of net pension liability, and ending balances of the components of net pension liability)
- Significant assumptions used to measure total pension liability, including inflation, salary changes, ad hoc postemployment benefit changes, discount rate, and mortality
- Measurement date of the net pension liability and the date of the actuarial valuation on which the liability is based
- Information about the plan fiduciary net position

Emphasis Point

Paragraph 43 of GASB Statement No. 68 requires note disclosures, including information about the plan's assets, deferred outflows of resources, liabilities, deferred inflows of resources, and fiduciary net position (that is, condensed financial information of the plan). However, if (*a*) a financial report that includes disclosure about the elements of the pension plan's basic financial statements is available on the Internet, either as a stand-alone financial report or included as a fiduciary fund in the financial report of another government and (*b*) information is provided about how to obtain the report, reference may instead be made to the other report for these disclosures. In this circumstance, other specific disclosures apply as discussed in paragraph 43.

- Amount of pension expense recognized by the employer in the reporting period
- Employer's balances of deferred outflows of resources and deferred inflows of resources related to pensions by type

Considerations for Pensions Not Administered Through a Qualifying Trust

Note disclosures are discussed in paragraphs 38–44 of GASB Statement No. 73 and are similar to those described in paragraph 13.104 with the following exceptions:

- The plan description should include the fact that there are no assets accumulated in a trust that meets the criteria in paragraph 4 of GASB Statement No. 73. If pensions are provided through a pension plan that is administered through a trust and that trust does not meet the criteria in paragraph 4 of GASB Statement No. 73, each criterion in paragraph 4 that the trust does not meet should be disclosed.
- Changes in total pension liability rather than net pension liability is disclosed.
- No disclosures related to plan fiduciary net position.

13.105 In addition, single and agent employers have to present certain 10-year schedules of RSI[15] and related notes as discussed in paragraphs 46–47 of GASB Statement No. 68, as amended, including information on the changes in the employer's net pension liability, key ratios, and information on contributions.

Considerations for Pensions Not Administered Through a Qualifying Trust

10-year schedules of RSI are discussed in paragraph 45 of GASB Statement No. 73 and focus on total pension liability as a percentage of covered-employee payroll.

Special Funding Situations

13.106 In GASB Statement No. 68, *special funding situations* are defined as circumstances in which a nonemployer entity is legally responsible for making contributions directly to a pension plan that is used to provide pensions to the employees of another entity or entities and either of the following criteria is met: (*a*) the amount of contributions for which the nonemployer entity

[15] Chapters 4 and 16 of this guide discuss the auditor's responsibility for, and reporting on, required supplementary information.

is legally responsible is not dependent upon one or more events unrelated to pensions, or (*b*) the nonemployer is the only entity with a legal obligation to make contributions directly to a pension plan.

13.107 An employer that has a special funding situation for defined benefit pensions is required to recognize a pension liability and deferred outflows of resources and deferred inflows of resources related to pensions with adjustments for the involvement of nonemployer contributing entities. The employer is required to recognize its proportionate share of the collective pension expense, as well as additional pension expense and revenue related to the expense recognized by the nonemployer contributing entities. The employer is also required to disclose in the notes to the financial statements information about the amount of support provided by nonemployer contributing entities and present similar information about the involvement of those entities in 10-year schedules of RSI. See paragraphs 83–91 of GASB Statement No. 68, as amended, for specific accounting and disclosure requirements related to special funding situations for single and agent employers.

13.108 The recognition and measurement of liabilities, deferred outflows of resources, deferred inflows of resources, and expense by a governmental nonemployer contributing entity in a special funding situation for defined benefit pensions is similar to that of cost-sharing employers. See paragraphs 97–117, as amended, of GASB Statement No. 68, as amended, for specific accounting and disclosure requirements related to special funding situations for nonemployer contributing entities.

Considerations for Pensions Not Administered Through a Qualifying Trust

Paragraph 19 of GASB Statement No. 73 defines special funding situations as circumstances in which a nonemployer entity is legally responsible for making contributions directly to the employees of another entity as the pensions come due and either of the following criteria is met: (*a*) the amount of benefit payments for which the nonemployer entity is legally responsible is not dependent upon one or more events unrelated to pensions, or (*b*) the nonemployer is the only entity with a legal obligation to make benefit payments as the pensions come due.

See paragraphs 78–96 of GASB Statement No. 73 for specific accounting and disclosure requirements related to special funding situations for nonemployer contributing entities.

Auditing Considerations for Single and Agent Employers

13.109 This section discusses considerations, including describing the relevant assertions, when auditing the pension information included in the employer's financial statements. This section does not include all risks or all procedures that could apply to such audits in accordance with generally accepted auditing standards; instead, it focuses on specific considerations for testing certain financial statement elements of the employer's financial statements affected by defined benefit pension plans, including net pension liability, deferred outflows of resources, deferred inflows of resources, and pension expense. The example substantive audit procedures are not considered required procedures, nor are they all-inclusive.

Determining Audit Strategy

13.110 It is important to note that regardless of the type of plan, the plan is not considered a component of the employer for purposes of AU-C section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* (AICPA, *Professional Standards*), discussed in Interpretation No. 1, "Auditor of Participating Employer in a Governmental Pension Plan," of AU-C section 600 (AICPA, *Professional Standards*, AU-C sec. 9600 par. .01–.02) (see the following emphasis point). Therefore, the employer auditor is solely responsible for determining the sufficiency and appropriateness of audit evidence necessary to reduce audit risk to an appropriately low level for the pension amounts in the audit of the employer's financial statements. That is, the audited financial statements of the plan will not, by themselves, provide the employer auditor sufficient appropriate audit evidence to support the components of net pension liability (that is, total pension liability and plan fiduciary net position). Absent additional evidence obtained, the employer auditor would not likely be able to accumulate sufficient appropriate audit evidence to support the pension amounts and disclosures in the employer's financial statements.

Emphasis Point

AU-C Section 9600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors): Auditing Interpretations of Section 600*

1. *Auditor of Participating Employer in a Governmental Pension Plan*

.01 *Question*—Many governmental entities (employers) provide pension benefits to their employees through governmental pension plans. In order to report pension amounts in accordance with GASB Statement No. 68, employers obtain certain information (for example, net pension liability) from the governmental pension plan. In this circumstance, is the governmental pension plan considered a component of the employer for purposes of section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*?

.02 *Interpretation*—No. In this circumstance, a governmental pension plan is not a component of the employer for purposes of section 600. Accordingly, it would not be appropriate for an employer auditor to make reference to the audit report of the governmental pension plan auditor.

13.111 Determining the audit strategy for the pension information in the employer financial statements requires the auditor to understand the type of plan (that is, single-employer, agent, or cost-sharing, as discussed in paragraph 13.08) and what activities the various parties (for example, plan or employer) perform. Example activities include investing and holding plan assets, maintaining records, receiving contributions, and disbursing benefits. In determining what activities are performed by the various parties, it is important for the auditor to understand the governance structure of both the plan and the employer.

13.112 Single-employer plans are often administered by the employer's personnel. Conversely, agent plans are almost always administered under a separate governance structure from the employer. The governance structure will affect what information is available to the employer and from whom it may be obtained. Employer management and the auditor will often need information from the plan in addition to the information maintained by the employer. The governance structure may also affect whether there are different auditors for the plan and the employer.

Considerations for Pensions Not Administered Through a Qualifying Trust

Pensions not administered through a qualifying trust are often administered by the employer's personnel. It is unlikely that such plans will have a separate governance structure from the employer.

13.113 Understanding the key elements of the plan document (for example, eligibility, contributions, vesting, and benefit payments) is necessary for the auditor to design an appropriate audit strategy.

13.114 The auditor uses the understanding of the type of plan and the party responsible for each activity to understand can go wrong to identify and assess the risks of material misstatement surrounding those activities in order to determine the nature, timing, and extent of audit procedures. (See chapter 4 of this guide for a discussion of the auditor's risk assessment and response to assessed risks.)

13.115 When activities are performed by the employer in a single-employer plan, controls responsive to the risks tested at the employer may help to reduce the extent of substantive procedures if those controls are operating effectively. Often, controls in effect at the employer specific to agent plans are limited, thus, there may be no benefit to testing operating effectiveness and a substantive approach may be appropriate.

Considerations Specific to Audits of Single Employers

13.116 The audit strategy for single employers may be affected by relationships between the plan, the employer, and their auditors. The following paragraphs provide different circumstances relevant to single employers. Careful consideration by the employer auditor of the relevant circumstances assists the auditor in designing appropriate audit procedures to obtain evidence on employer pension amounts and census data.

13.117 If the plan is not otherwise audited or if the employer auditor has been engaged to audit the plan, the employer auditor is responsible for performing all the substantive audit procedures on the pension amounts. When auditing both the plan and the employer, the auditor may design the audits so as to obtain sufficient appropriate audit evidence to support the opinions on both the plan financial statements and the employer financial statements. In this circumstance, the auditor should evaluate the appropriate performance materiality (see chapter 4 of this guide for a further discussion of performance materiality) for purposes of performing the plan and employer audits. In many circumstances, procedures performed to obtain sufficient appropriate audit evidence on the pension amounts for the employer will be performed using a lower performance materiality than that needed for the audit of the plan financial statements. Accordingly, when the auditor is performing procedures to obtain evidence for both the plan and the employer financial statements, the procedures should be performed using the lowest materiality of the applicable opinion units.

13.118 In circumstances in which the plan is audited by another auditor, the employer auditor evaluates the degree of evidence the audited financial statements of the plan may provide. In performing this evaluation, the auditor considers the reporting unit (and related opinion unit) that the plan auditor is opining on to better understand the likely performance materiality used for the audit of the plan. For example, although the financial statements for a PERS include a combining financial statement for all plans administered, those financial statements represent a single opinion unit. Therefore, the auditor of the PERS generally plans and performs the plan audit based on a performance materiality established for the opinion unit as a whole and not for each separate plan (assuming the plan auditor was not engaged to report at a lower level than the single opinion unit). In this circumstance, the audited PERS financial statements would likely provide little, if any, audit evidence for the employer auditor. In contrast, if the plan auditor is engaged to issue a separate opinion on the individual plan financial statements, this may provide some audit evidence for the employer auditor. However, even in this circumstance, the employer auditor would require additional audit evidence on the pension amounts, including the completeness and accuracy of census data maintained by the plan. A method for obtaining evidence related to such census data is for employer management to request that plan management engage its auditor to perform an examination engagement in accordance with AT-C section 205 over census data controlled by the plan as discussed in paragraph 13.128.

13.119 A potentially more efficient method for the employer auditor to obtain evidence on the employer pension amounts when another auditor audits the plan is for employer management to request that plan management engage its auditor to obtain reasonable assurance and report on net pension liability, total deferred outflows of resources, total deferred inflows of resources, and pension expense of the employer (similar to the proposed solutions described in appendix B for cost-sharing employers). This approach would likely involve minimal additional audit effort by the plan auditor (in comparison to the plan auditor being engaged to issue a separate opinion on the individual plan financial statements) while reducing the audit procedures performed by the employer auditor. This would also likely alleviate the need for the employer auditor to obtain additional audit evidence on the census data maintained by the plan; thus, an examination engagement over census data discussed in paragraph 13.118 would not be necessary.

Considerations Specific to Audits of Agent Employers

13.120 Each agent employer will be challenged about how to obtain all information to support the specific pension amounts presented in its financial statements, including net pension liability, deferred outflows of resources, deferred inflows of resources, and pension expense. Specific pension amounts are dependent on certain accounting records maintained by the plan, the controls and processes of the plan, as well as the calculations by the plan's actuary. The employer is solely responsible for its financial statements and, therefore, it is employer management's responsibility to establish financial reporting processes and controls over the recognition, measurement, presentation, and disclosure of its various pension amounts.

13.121 Similarly, employer auditors will be challenged in terms of obtaining sufficient appropriate evidence regarding the specific pension amounts included in employer financial statements. AU-C section 500 states that the objective of the auditor is to design and perform audit procedures that enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.

13.122 Appendix A provides a two-part approach to address the challenges of employers and their auditors (including the census data considerations discussed in paragraphs 13.123–.128). The first part addresses total pension liability, deferred outflows of resources, deferred inflows of resources, and pension expense, and the second part addresses the employer's specific interest in the agent plan's fiduciary net position. The substantive audit procedures included in this chapter for audits of agent employers assume that the agent plans provide employers with the recommended information and related audit reports discussed in appendix A.

Emphasis Point

In accordance with Interpretation No. 3, "Auditor of Participating Employer in a Governmental Agent Multiple-Employer Pension Plan," of AU-C section 500 (AICPA, *Professional Standards*, AU-C sec. 9500 par. .30–.36), it is important for employer auditors to understand that obtaining the audited plan financial statements and additional unaudited information provided by the plan's management to calculate the employer's net pension liability will not provide sufficient appropriate audit evidence to support the relevant assertions in the employer's financial statements.

AU-C Section 9500, *Audit Evidence: Auditing Interpretations of Section 500*

3. Auditor of Participating Employer in a Governmental Agent Multiple-Employer Pension Plan

30. *Question*—GASB Statement No. 68 requires governmental entities (employers) participating in governmental agent multiple-employer pension plans (agent plan or plan) to present certain pension amounts in employer financial statements that are calculated by the plan or its actuary. Such amounts are based, in part, on records maintained only by the plan.

.31 Do the audited financial statements of the plan prepared in accordance with GAAP and additional unaudited information provided by the plan's management necessary to calculate the employer's net pension liability provide the employer's auditor with sufficient appropriate audit evidence upon which to base the opinion on the affected opinion units of the governmental employer financial reporting entity?

.32 *Interpretation*—No. GASB Statement No. 67 does not require the plan to present net pension liability, deferred outflows of resources or deferred inflows of resources by category, pension expense, or each participating employer's specific pension amounts. Unaudited information provided by the plan's management to the employers to support allocations or pension amounts that has not been subjected to further audit procedures beyond those performed in the audit of the basic plan financial statements would not constitute sufficient appropriate audit evidence to support the relevant assertions in the employer's financial statements related to the pension amounts, including required disclosures.

.33 Absent additional evidence obtained, for example, through the suggested best practices as described in the AICPA's State and Local Governments Expert Panel white paper, *Governmental Employer Participation in Agent Multiple-Employer Plans: Issues Related to Information for Employer Reporting*,[16] the employer auditor would not likely be able to accumulate sufficient appropriate audit evidence to support the pension amounts and disclosures in the employer's financial statements. When pension amounts are material to one or more applicable opinion units of the employer's financial statements and the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements of those opinion units are free from material misstatement, the auditor should modify the audit opinion pursuant to section 705.

.34 *Question*—A plan has engaged its auditor to audit and report on the schedule of changes in fiduciary net position by employer, as described in the AICPA's State and Local Governments Expert Panel white paper referenced in paragraph .33 of this interpretation. May an employer auditor use the plan auditor's report as evidence about the fiduciary net position and changes in fiduciary net position for the audit of the employer's financial statements?

.35 *Interpretation*—Yes. The employer auditor is solely responsible for the audit of the employer's financial statements and, therefore, is responsible for determining the sufficiency and appropriateness of audit evidence necessary to reduce audit risk to an appropriately low level. Nevertheless, the employer auditor may use the plan auditor's report on the schedule as evidence about both the fiduciary net position and changes in fiduciary net position of the employer. However, the employer auditor should consider whether the opinion is on the schedule as a whole or on each employer column. If the opinion is on the schedule as a whole, it is likely that the employer auditor will need additional evidence to support these amounts in the employer's financial statements (examples of such audit evidence are included in the white paper referenced in paragraph .33 of this interpretation).

.36 Before using the work of the plan auditor as evidence, the employer auditor should evaluate whether the plan auditor's report and accompanying schedule are adequate and appropriate for the employer auditor's purposes. For example, the employer auditor may review the plan auditor's report and any related opinion modifications and assess other matters discussed in the report. Additionally, the employer auditor should evaluate whether the plan auditor has the necessary competence and independence for the employer auditor's purposes.

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[16] The contents of the AICPA's State and Local Governments Expert Panel white paper, *Governmental Employer Participation in Agent Multiple-Employer Plans: Issues Related to Information for Employer Reporting*, are included in appendix A to this chapter.

Considerations for Pensions Not Administered Through a Qualifying Trust

As pensions not administered through a qualifying trust do not typically have a separate governance structure, the most likely scenario for such plans is discussed in paragraph 13.117.

Census Data

13.123 As discussed in paragraphs 13.11–.15, certain financial statement elements of single and agent employers that participate in defined benefit pension plans (that is, net pension liability, deferred outflows of resources, deferred inflows of resources, and pension expense) are dependent on members' demographic data (census data). The employer auditor's consideration of the relevant financial statement assertions that are dependent on census data begins with understanding the processes and internal control used by the employer and the plan to support the completeness and accuracy of significant elements of census data that are provided to the actuary.

13.124 *Significant elements of census data* include those elements that, either individually or when combined with other elements, could result in a material misstatement to one or more elements of the employer's financial statements (that is, net pension liability, deferred outflows of resources, deferred inflows of resources, and pension expense). Significant elements of census data may include some or all of the following:

a. Name
b. Social Security number
c. Date of birth
d. Date of hire
e. Marital status
f. Pensionable wages
g. Service credits (periods of time worked)
h. Class of employee
i. Position or job code (or both)
j. Contributions
k. Gender
l. Date of termination or retirement
m. Spouse's date of birth
n. Employment status (active, inactive entitled to but not receiving benefits, retired).

The significance of some of these elements, all of these elements, or additional elements to any plan will be based on the impact that a particular census data element has on the measurement of a particular financial statement element.

13.125 The substantive procedures over census data at the employer are ordinarily based on a concept that focuses on testing incremental changes (see paragraph 13.15) to the census data file since the prior actuarial valuation, assuming (*a*) the prior year financial statements were audited, (*b*) there were no modifications to the auditor's report in the prior year related to census data, and (*c*) the auditor has concluded there is no significant risk of material misstatement due to incomplete or inaccurate census data from prior years. These procedures would ordinarily cover the census data reported to the plan during (1) the year immediately preceding the actuarial valuation when the actuarial valuation is performed on an annual basis or (2) the two-year period immediately preceding the actuarial valuation when the actuarial valuation is performed on a biennial basis.

13.126 When the governance structure of the plan and employer are the same, the underlying records are typically maintained by the same party. This is usually the case for most single-employer plans. In this circumstance, the employer would likely have access to the underlying records of both the active and inactive members and test the underlying data of selected members each year to obtain sufficient appropriate evidence that the significant elements of census data reported to the actuary are complete and accurate.

13.127 When the plan and employer are under different governance structures, as discussed in paragraph 13.12, the underlying records that support the census data are maintained by different parties. This is almost always the case for agent plans and sometimes the case for single-employer plans. When different governance structures exist, the underlying records of active members are typically maintained by the employers. The underlying records of plan members who are no longer employed by the government (that is, inactive members) are typically maintained by the plan. The underlying records of active members maintained by the employer for purposes of testing the *significant elements of census data* that were reported to the plan during the period could be tested by the employer auditor, but access to information for the census data maintained by the plan necessitates additional support from the plan and the plan's auditor.

13.128 To address this and other challenges of agent employers and their auditors, appendix A of this chapter includes two options for the agent employer auditor to obtain evidence from the plan related to census data. The first option is for the plan to engage an auditor to issue a type 2 SOC 1 report on controls over census data maintained by the plan. The second option is for the plan to engage an auditor to perform an examination engagement in accordance with AT-C section 205, on plan management's assertion relating to the completeness and accuracy of census data maintained by the plan. Additional responsibilities of the employer auditor related to census data are discussed in paragraph 13.136.

Special Funding Situations

13.129 Some single-employer and agent plans include *special funding situations*, as discussed in paragraph 13.106. The audit guidance in this chapter does not address special funding situations. If such a situation exists, the employer auditor should perform appropriate audit procedures.

13.130 As GASB Statement No. 68 provides specific criteria to be considered a special funding situation, careful evaluation of the employer's documentation to substantiate whether there is, or is not, a special funding situation is necessary. Such documentation may need to include a legal opinion if the relevant statutes or plan document are not specifically based on the criteria in GASB Statement No. 68. For financial reporting purposes, such legal opinion should be based on the criteria for a special funding situation in GASB Statement No. 68, as opposed to a legal notion of liability or obligation.

Considerations for Pensions Not Administered Through a Qualifying Trust

Paragraphs 19–20 of GASB Statement No. 73 provide specific criteria to be considered a special funding situation.

Net Pension Liability, Deferred Outflows of Resources, Deferred Inflows of Resources, and Pension Expense for Single and Agent Employers

13.131 In addition to the discussion in chapter 4 of this guide related to the auditor's risk assessment and understanding of the entity, auditor considerations specific to total pension liability, net pension liability, deferred outflows of resources, deferred inflows of resources, and pension expense include obtaining an understanding of the actuary's objectives, scope of work, methods and assumptions, and consistency of application.

Considerations for Pensions Not Administered Through a Qualifying Trust

References to net pension liability and fiduciary net position are not applicable to pensions not administered through a qualifying trust. Unless otherwise noted, references to GASB Statement No. 68 should be replaced with GASB Statement No. 73.

Relevant Assertions

13.132 The relevant assertions related to net pension liability, deferred outflows of resources, deferred inflows of resources, and pension expense for single and agent employers include the following:

a. Member census data reported to the plan is complete and accurate.

b. Member census data accumulated and maintained by the plan is complete and accurate.

c. Actuarial assumptions used in computing the total pension liability are in accordance with GASB Statement No. 68 and the Actuarial Standards of Practice.

d. The employer pension amounts, including net pension liability, deferred outflows of resources, deferred inflows of resources, and pension expense have been properly calculated and reported in the financial statements in accordance with GASB Statement No. 68 and in the proper period and are properly disclosed.

Examples of Identified Risks of What Can Go Wrong at the Relevant Assertion Level

13.133 The following are examples of identified risks of what can go wrong at the relevant assertion level related to net pension liability, deferred outflows of resources, deferred inflows of resources, and pension expense for single and agent employers:

Net Pension Liability

a. The actuary does not have the appropriate qualifications or related experience to perform the valuation.

b. Members are inappropriately excluded from, or included in, the census data.

c. Census data does not reconcile to (agree with) the employer's payroll and personnel records, causing errors in the computation of total pension liability.

d. The plan does not properly accumulate (maintain) the census data based on information reported by the employer for active members as well as activity for census data controlled by the plan for inactive members, causing errors in the computation of total pension liability.

e. The actuary uses incomplete (missing) or incorrect census data, causing errors in the computation of total pension liability.

f. The actuary uses inappropriate assumptions or actuarial methods that are not in conformity with GASB Statement No. 68 and the Actuarial Standards of Practice, causing errors in the computation of total pension liability. Examples of inappropriate assumptions or actuarial methods include the following:

   i. Using an actuarial cost method other than entry age normal for computing the total pension liability

   ii. Using a long-term rate of return that does not reflect the future expected rate of return on plan investments based on investment strategy and target asset allocations

   iii. Using inappropriate cash flow projections when calculating the discount rate

   iv. Using mortality assumptions that do not properly reflect expected future improvement in mortality rates

g. Projected benefit payments used in the actuarial valuation do not include all benefits to be provided to plan members in accordance with the benefit terms that are in force at the measurement date, causing the inaccurate computation of the total pension liability.

h. Projected benefit payments used in the actuarial valuation do not include the effects of automatic postemployment benefit changes, ad hoc benefit changes that are substantively automatic or projected salary changes, causing the inaccurate computation of the total pension liability.

i. Plan amendments or changes in benefit terms have not been properly included or excluded as of the measurement date.

j. The fiduciary net position used in calculating the net pension liability as of the measurement date is not the same as the fiduciary net position reported in the plan's statement of fiduciary net position.

Considerations for Pensions Not Administered Through a Qualifying Trust

Changes to the identified risks of what can go wrong for total pension liability for pensions not administered through a qualifying trust are as follows:

- Paragraphs 13.133*f*(ii) and 13.133*f*(iii): The discount rate for pensions not administered through a qualifying trust should be a yield or index rate for 20-year, tax-exempt general obligation municipal bonds with an average rating of AA/Aa or higher (or equivalent quality on another rating scale) in accordance with paragraph 31 of GASB Statement No. 73. Therefore, these risks are not relevant.
- Paragraph 13.133*j*: This risk is not relevant as fiduciary net position is not applicable to such pensions.

Deferred Outflows of Resources and Deferred Inflows of Resources

k. Deferred outflows of resources and deferred inflows of resources are not properly calculated and reported in accordance with GASB Statement No. 68.

l. Changes in benefit terms have been incorrectly reported as deferred outflows of resources or deferred inflows of resources.

m. The amortization period used to recognize (amortize) deferred outflows of resources and deferred inflows of resources for each respective year's incremental deferrals has not been properly calculated in accordance with GASB Statement No. 68. For example, the plan incorrectly calculates the amortization period for changes in assumptions based on the average remaining service lives of active employees, instead of the average remaining service lives of all employees (that is, active and inactive plan members).

n. Contributions to the plan subsequent to the measurement date are not recognized as a deferred outflow of resources.

Considerations for Pensions Not Administered Through a Qualifying Trust

Changes to the identified risks of what can go wrong for deferred outflows of resources and deferred inflows of resources for pensions not administered through a qualifying trust are as follows:

- Paragraph 13.133*n*: Replace this risk with, "Amounts paid for pensions as the benefits become due subsequent to the measurement date are not recognized as a deferred outflow of resources."

Pension Expense

o. Pension expense is not properly calculated and reported in accordance with GASB Statement No. 68.

p. Contributions to the plan are directly considered in pension expense.

q. Pension expense does not properly reflect the impact of service cost (addition) and employee contributions (deduction) based on the actuarial valuation used to measure net pension liability.

r. Pension expense does not properly reflect the interest on the total pension liability (addition) and projected earnings on plan investments (deduction).

s. Pension expense does not include the appropriate amount for the recognition (amortization) of deferred outflows of resources and deferred inflows of resources.

t. Pension expense does not include changes in benefit terms.

Considerations for Pensions Not Administered Through a Qualifying Trust

Changes to the identified risks of what can go wrong for pension expense for pensions not administered through a qualifying trust are as follows:

- Paragraph 13.133*p*: Replace this risk with, "Amounts paid for pensions as the benefits become due are directly considered in pension expense."
- Paragraph 13.133*q*: As there are no employee contributions to such a plan, there is no impact to pension expense. Therefore, this risk is not relevant.
- Paragraph 13.133*r*: This risk is not relevant because there are no plan investments.
- Add the following risk: "Pension expense does not include costs incurred by the employer related to the administration of pensions."

Example Audit Procedures to Consider

Total Pension Liability (Component of Net Pension Liability)

13.134 The following are examples of substantive procedures for auditing the total pension liability component (excluding census data) of net pension liability for single and agent employers:

a. Obtaining the actuarial valuation report used to measure the total pension liability as of the measurement date based on GASB Statement No. 68.

Emphasis Point

Plans often have different actuarial valuations performed for accounting (for example, accounting pursuant to GASB Statement No. 68) and funding (for example, actuarially determined contribution) purposes. The employer should provide to the employer auditor a complete actuarial valuation report that has been prepared for accounting purposes that includes an actuarial certification.

Emphasis Point for Agent Employers

Each employer participating in an agent plan requires a separate actuarial valuation based on each employer's specific census data and plan provisions. In order for the agent employer and the employer auditor to consider the actuary as a management specialist[17] for the indicated pension amounts, employer management needs to obtain an actuarial valuation report specific

[17] A *management's specialist* is an individual or organization possessing expertise in a field other than accounting or auditing whose work in that field is used by the entity to assist the entity in preparing the financial statements. AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*), addresses the auditor's responsibilities when information to be used as audit evidence has been prepared using the work of a management's specialist.

to their entity. Appendix A includes a recommendation that the actuary of the plan issue a separate actuarial valuation report for and addressed to each employer in the plan, which would include total pension liability, fiduciary net position, net pension liability, deferred outflows of resources and deferred inflows of resources by category and year, pension expense, the discount rate calculation (including comparing projections of the pension plan's fiduciary net position to projected benefit payments), and other standard actuarial information. Appendix A also includes a recommendation that the actuarial certification be addressed to employer management.

b. Evaluating the professional qualifications of the actuary, including his or her competence, capabilities, and objectivity as required by paragraph .08 of AU-C section 500. If the actuary is not known to the auditor, consider other factors that might provide information regarding the actuary's qualifications, such as (i) the actuary's membership in a recognized professional organization, (ii) the number and types of public pension plans served, including years of experience, and (iii) the opinion of other actuaries whom the auditor knows to be qualified regarding the actuary's professional qualifications.

Emphasis Point

Paragraph .12 of AU-C section 300 states the auditor should consider whether specialized skills are needed in performing an audit. Consideration of the engagement team's skills, knowledge, and experience as they relate to understanding actuarial information is critical in such engagements. If specialized skills are needed, consider using an auditor specialist (for example, an actuary) in evaluating the appropriateness of the actuarial valuation and the measurement of the total pension liability.

c. Inquiring about the nature of any interests or relationships the actuary may have with the plan or employer(s) that may create threats to the actuary's objectivity (for example, financial interests, business or personal relationships, or the provision of other services) and any applicable safeguards.

Emphasis Point

Although safeguards cannot eliminate all threats to the objectivity of an actuary, threats such as intimidation by management may be of less significance to a specialist engaged versus employed by the plan or plan administrator, and the effectiveness of safeguards such as quality control procedures may be greater. This evaluation of objectivity may be accomplished by the auditor asking management to have the actuary describe in writing interests and relationships, if any, that may exist and that may appear to impair the objectivity of the actuary.

d. Reading the actuarial certification for potential exclusions from the scope of the actuary's work or qualifications on the actuary's certification relating to actuarial methods, actuarial assumptions, or census data.

e. Inquiring of management or the actuary whether the actuarial valuation considers all pertinent provisions of the plan, including any changes or amendments to the plan or other events affecting the actuarial calculations that are effective as of the measurement date.

f. Determining whether the actuarial valuation was performed as of a date no more than 30 months and 1 day from the employer's fiscal year-end.

g. Evaluating whether the methods and assumptions used in determining the total pension liability are in accordance with GASB Statement No. 68 and Actuarial Standards of Practice and are the same as those used by the plan. See examples of identified risks of what can go wrong related to actuarial assumptions in paragraph 13.133*f*.

h. If the actuarial valuation was performed as of a date prior to the measurement date, reviewing the appropriateness of the update procedures to roll forward the total pension liability to the measurement date and determining whether all significant known events occurring between the valuation date and the measurement date have been properly included.

i. Testing the reliability and completeness of the member census data used. See paragraphs 13.135–.136 for specific procedures.

j. Evaluating the propriety of the long-term expected rate of return used in the calculation of the discount rate.

Emphasis Point

Paragraph 30 of GASB Statement No. 68 requires the long-term expected rate of return used in the calculation of the discount rate to be forward-looking and be based on the appropriate expected long-term rate of return considering target asset allocations. It is often developed using a building-block approach based on portfolio modeling. Employer management should evaluate the appropriateness of the rate each year based on current information. When evaluating the reasonableness of management's assumption regarding the long-term expected rate of return, the auditor is cautioned to avoid evaluating the reasonableness of this assumption solely based on retrospective analysis of historical investment returns or comparison to the rate used by other plans.

k. Evaluating whether the discount rate is reasonable and is a single rate in accordance with GASB Statement No. 68.

   i. Obtaining the discount rate calculation and supporting schedules as of the measurement date.

   ii. Testing the mathematical accuracy of the discount rate calculation and supporting schedules.

iii. Performing the following procedures on the components[18] of the projection of the plan fiduciary net position (that is, net position roll forward):

(1) Tracing beginning plan fiduciary net position to audited plan financial statements.

(2) Comparing employer (including nonemployer contributing entity, if applicable) and employee contributions in (future) year one to actual contributions in current year audited plan financial statements.

(3) Evaluating reasonableness of projected future employer (including nonemployer contributing entity, if applicable) and employee contributions based on age demographics of active plan members. As active plan members retire, projected future contributions will decrease dramatically as employer and employee contributions related to future employees are excluded.

(4) Evaluating appropriateness of projected future employer (including nonemployer contributing entity, if applicable) contributions based on the criteria in paragraph 28 of GASB Statement No. 68.

Emphasis Point

As discussed in paragraphs 28–29 of GASB Statement No. 68, employer management should apply professional judgment to project cash flows for contributions from the employer and nonemployer contributing entities in circumstances in which (*a*) those contribution amounts are established by statute or contract or (*b*) a formal, written policy related to those contributions exists. Employer management's application of professional judgment should consider the most recent five-year contribution history (to determine the degree of adherence to preceding [*a*] and [*b*]) of the employers and nonemployer contributing entities as a key indicator of future contributions from those sources and should reflect all other known events and conditions.

In circumstances in which a statute or formal written policy exists that requires increasing contribution rates in future years, employer management's application of professional judgment will likely be challenging with respect to determining whether to consider such funding in projected cash flows for contributions. Further, in evaluating the appropriateness of the employer management's judgment about future contributions, the auditor considers the most recent five-year history and evaluates the likelihood that the increased contribution will be made. In evaluating the likelihood that increased contributions will be made, the auditor may consider whether the government has a history of amending similar statutes and written policies due to the inability to make the required contributions.

[18] Components would include projected beginning fiduciary net position by year, projected contributions for the year, projected benefit payments for the year, projected investment return for the year, projected administrative expenses for the year, and ending fiduciary net position.

In circumstances other than those described in (*a*) and (*b*), the amount of projected cash flows for contributions from the employer and nonemployer contributing entities should be limited to an average of contributions from those sources over the most recent five-year period (percentage of covered payroll contributed or percentage of actuarially determined contributions made) and may be modified based on consideration of subsequent events.

(5) Comparing (future) year one benefit payments to actual benefit payments in the current year audited plan financial statements.

(6) Evaluating reasonableness of projected future benefit payments based on age demographics of current plan members, projected retirement dates, projected benefit payments based on the applicable benefit formula, and mortality assumptions used in the actuarial valuation.

(7) Recalculating investment earnings by year based on the long-term expected rate of return.

iv. Performing the following on the calculation of actuarial present values of the projected benefit payments:

(1) Tracing beginning fiduciary net position each year and projected benefit payments to net position roll forward tested previously.

(2) For future years in which beginning fiduciary net position is sufficient to pay projected benefits for the respective year, determining whether the projected benefit payments were properly discounted using the long-term expected rate of return on plan investments.

(3) For future years in which beginning fiduciary net position is not sufficient to pay projected benefits for the respective year, determining whether the projected benefit payments were properly discounted using an appropriate 20-year AA municipal bond yield or index rate as of the measurement date.

(4) Recalculating the single (blended) discount rate.

l. Verifying that the fiduciary net position used in calculating the net pension liability is the same as the fiduciary net position reported in the plan's statement of fiduciary net position.

m. Recomputing the calculation for the *net pension liability*, this is the total pension liability less the plan fiduciary net position as of the measurement date.

Considerations for Pensions Not Administered Through a Qualifying Trust

The previous examples of substantive procedures for auditing the total pension liability component (excluding census data) have the following modifications for pensions not administered through a qualifying trust:

- Paragraph 13.134*j*: Delete this procedure as the long-term expected rate of return is not applicable to such pensions.
- Paragraph 13.134*k*: Replace this procedure and all subbullets with, "Evaluating whether the discount rate is in accordance with paragraph 31 of GASB Statement No. 73, such that the discount rate should be a yield or index rate for 20-year, tax-exempt general obligation municipal bonds with an average rating of AA/Aa or higher (or equivalent quality on another rating scale)."
- Paragraph 13.134*l* and *m*: Delete these procedures as fiduciary net position is not applicable to such pensions.

Census Data—Single Employers

Emphasis Point

As addressed in paragraph 13.125, the substantive procedures over census data at the employer are ordinarily based on a concept that focuses on testing incremental changes (see paragraph 13.15) to the census data file since the prior actuarial valuation, assuming (*a*) the prior year financial statements were audited, (*b*) there were no modifications to the auditor's report in the prior year related to census data, and (*c*) the auditor has concluded there is no significant risk of material misstatement due to incomplete or inaccurate census data from prior years. These procedures would ordinarily cover the census data reported to the plan during the year immediately preceding the actuarial valuation when the actuarial valuation is performed on an annual basis.

If the plan performs biennial valuations, the census data to be tested for the 20X6 valuation would be that reported to the plan since the last valuation (that is, 24-months ending July 1, 20X6).

For example, if an employer has a year-end of June 30, 20X5 and uses a measurement date of June 30, 20X4 based on an actuarial valuation that was performed as of July 1, 20X3 and rolled forward to the measurement date of June 30, 20X4, the focus of the procedures would ordinarily be over the changes to the census data that occurred during the year ended June 30, 20X3.

13.135 The following are examples of substantive procedures when auditing census data used in the measure of total pension liability for single employers:

a. Reviewing the actuarial certification (in the actuarial valuation report) to determine whether there were any exceptions identified related to the census data and testing resolution as necessary.

b. Obtaining the census data file sent to the actuary from either the actuary or the plan. If obtained from the plan, obtaining evidence that information obtained from the plan was the same information reported to and used by the actuary (for example, obtaining a written confirmation from the actuary).

c. Confirming with the actuary whether there was any missing information or changes made to the census data file provided by plan management.

d. Evaluating the potential impact of assumptions used by the actuary in changing census data (for example, corrections to address missing data) on the total pension liability.

e. Obtaining and testing a reconciliation of aggregate census data to the actuarial valuation report (for example, the number of members and pensionable wages reported in the census data file to amounts shown in the actuarial valuation report).

f. Obtaining and testing a roll forward of the census data from the prior valuation to the current valuation, including testing significant reconciling items.

g. Comparing the number of plan members for the current year versus the prior year, as well as the number of plan members versus the number of employees. Consider disaggregating the analysis in various ways (for example, by age of employee, and status [active, inactive employees entitled to but not yet receiving benefits, or inactive employees or their beneficiaries receiving benefits]).

h. Obtaining a list of new employees hired during the period from the prior valuation to the current valuation from the employer and performing the following procedures:

   i. Selecting a sample to determine that eligible new employees were appropriately enrolled in the plan and properly included in the census data file

   ii. For each employee selected, verifying the accuracy of significant elements of census data from enrollment that are in the census data file to the human resources (personnel) records (for example, name, Social Security number, date of birth, gender, date of hire, marital status, and position or job code)

i. Identifying the payroll registers and payroll cycles for all reporting units of the government.

j. Selecting a sample of active members and performing the following procedures:

> ***Emphasis Point***
>
> Consider selecting a sample of active members from the employer's payroll registers throughout the year and a sample from the census data file.

   i. Evaluating whether the employee is eligible to participate in the plan based on the eligibility criteria included in the plan document (state statutes).

   ii. Comparing the static census data (for example, name, date of birth, date of hire, gender, and spouse's date of birth) in the current census data file to the prior census data file.

   iii. For significant elements of census data that change based on current-year events and activity (for example, service credits, pensionable wages, and marital status), verifying the incremental changes to the payroll and personnel records and recalculating the census data in the current census data file based on the prior census data file and the incremental changes for the period (see paragraph 13.15).

> ***Emphasis Point***
>
> The following procedures (items *k* and *l*) pertaining to inactive member data may not be necessary when the employer auditor obtains evidence from the plan. See paragraphs 13.118–.119.

k. Selecting a sample of inactive members entitled to but not yet receiving benefits and comparing the census data information from the current census data file to the prior census data file (or vice versa).

> ***Emphasis Point***
>
> Consider selecting a sample of inactive members entitled to but not yet receiving benefits from the current census data file and a sample from prior census data file.

l. Selecting a sample of inactive members currently receiving benefits and performing the following procedures:

> ***Emphasis Point***
>
> Consider selecting a sample of inactive members currently receiving benefits from the current census data file and a sample from prior census data file. As an alternative, consider using a sample from benefit payments testing and verifying name, benefit type, and amount to the census data file.

i. Comparing the static census data information from the current census data file to the prior census data file.

ii. Verifying or recalculating the significant elements of census data that change based on criteria in the plan document (for example, verifying the retirement benefit by comparing the benefit payment in the prior census data file and recalculating the current benefit payment based on the cost of living adjustment for the current year).

iii. Comparing the benefit payments included in the census data file to the general ledger detail.

iv. Determining that the retiree (or beneficiary, if applicable) is not deceased based on a cross-match of Social Security numbers.

<u>Census Data—Agent Employers</u>

13.136 The following are examples of substantive procedures when auditing census data used in the measure of total pension liability for agent employers (see the emphasis point preceding paragraph 13.135):

a. Reviewing the actuarial certification (in the actuarial valuation report addressed to the employer) to determine whether there were any exceptions identified related to the census data and testing resolution as necessary.

b. Obtaining the census data file sent to the actuary from either the actuary or the plan. If obtained from the plan, obtaining evidence that information obtained from the plan was the same information reported to and used by the actuary (for example, obtaining a written confirmation from the actuary).

c. Confirming with the actuary whether there was any missing information or changes made to the census data file provided by plan management.

d. Evaluating the potential impact of assumptions used by the actuary in changing census data (for example, corrections to address missing data) on the total pension liability.

e. Obtaining and testing a reconciliation of aggregate census data to the actuarial valuation report (for example, the number of members and pensionable wages reported in the census data file to amounts shown in the actuarial valuation report).

f. Obtaining and testing a roll forward of the census data from the prior valuation to the current valuation, including testing significant reconciling items.

g. Comparing the number of plan members for the current year versus the prior year, as well as the number of plan members versus the number of employees. Consider disaggregating the analysis (for example, by age of employee, status [that is, active, inactive employees entitled to but not yet receiving benefits, or inactive employees or their beneficiaries receiving benefits]).

h. Obtaining a list of new employees hired during the period from the prior valuation to the current valuation from the employer and performing the following procedures:

   i. Selecting a sample to determine that eligible new employees were appropriately enrolled in the plan and properly included in the employer (payroll) transmission reports and census data file

   ii. For each employee selected, verifying the significant elements of census data reported to the plan upon enrollment to the human resources (personnel) records (for example, name, Social Security number, date of birth, gender, date of hire, marital status, and position or job code)

i. Obtaining a list of status changes reported to the plan during the period from the prior valuation to the current valuation (other than those reported through the employer [payroll] transmission reports) and selecting a sample to determine that they were appropriate based on the relevant plan criteria and underlying payroll and personnel records.

j. Selecting a sample of active members and performing the following procedures:

> ***Emphasis Point***
>
> Consider selecting a sample from the employer's payroll registers throughout the year and the employer (payroll) transmission reports throughout the year.

i. Agreeing details included in the employer (payroll) transmission report (for example, name, position or job code, periods of time worked, pensionable wages for the period, employer contribution for the period, and employee contribution for the period) to the payroll register (or vice versa) and agree the underlying information to the payroll and personnel records

ii. Evaluating whether the selected employee is eligible to participate in the plan based on the eligibility criteria included in the plan document (state statutes)

iii. Recalculating service credits

k. Selecting a sample of employees from the employer's payroll system to determine whether they are properly enrolled in the plan and included in the census data file or properly excluded from the plan.

Additional Procedures Related to Census Data Maintained by the Plan

l. Obtaining from the plan evidence over the completeness and accuracy of census data maintained by the plan. For example, either (i) a type 2 SOC 1 report on controls over census data maintained by the plan or (ii) an examination report (opinion) in accordance with AT-C section 205 on plan management's assertion relating to the completeness and accuracy of census data maintained by the plan (see appendix A).

m. Evaluating whether the plan auditor's report (type 2 SOC 1 report or examination report in accordance with AT-C section 205) is adequate and appropriate for the employer auditor's purposes.

> ***Emphasis Point***
>
> Before using the work of the plan auditor as evidence, regardless of whether the type 2 SOC 1 or examination-level reporting options related to the census data maintained by the plan (see appendix A) are used, the employer auditor should evaluate whether the plan auditor's report is adequate and appropriate for the employer auditor's purposes. For purposes of this evaluation, the employer auditor may review the plan auditor's report and any related opinion modifications or exceptions and assess other matters discussed in the report. If a type 2 SOC 1 report is obtained, employer auditors should apply the guidance in AU-C section 402, *Audit Considerations Relating to an Entity Using a Service Organization* (AICPA, *Professional Standards*), to properly utilize the report. Paragraph .13*a* of AU-C section 402 requires when determining the sufficiency and appropriateness of the audit evidence provided by a type 2 SOC 1 report, the employer auditor should be satisfied that the auditor providing the type 2 SOC 1 report is competent and independent from the plan.

Fiduciary Net Position (Component of Net Pension Liability)—Single Employers

Considerations for Pensions Not Administered Through a Qualifying Trust

This following section addressing the fiduciary net position component of net pension liability is not applicable to pensions not administered through a qualifying trust.

Emphasis Point

The following three paragraphs provide example substantive audit procedures under different circumstances relevant to single employers. Careful consideration by the employer auditor of the relevant circumstances is necessary in order to select which paragraph is most applicable. See paragraphs 13.116 –.119.

Paragraph 13.137 provides guidance when the employer auditor is performing substantive audit procedures on certain elements (accounts) of the plan financial statements, regardless of whether the employer auditor has been engaged to issue a separate opinion on the plan financial statements. These procedures assume that another auditor has not been engaged to audit the plan financial statements.

Paragraph 13.138 provides guidance for the employer auditor when another auditor has been engaged to issue an opinion on the financial statements of the (individual) plan. As discussed in paragraph 13.118, the audited PERS financial statements that report more than one plan likely will provide little, if any, audit evidence for the employer auditor unless the plan auditor had been engaged to issue separate opinions on the individual plans' financial statements.

Paragraph 13.139 provides guidance when the plan prepares a schedule of pension amounts that includes total pension liability, fiduciary net position, and net pension liability, for which the plan engages its auditor to obtain reasonable assurance and report on the net pension liability in accordance with AU-C section 805, *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement* (AICPA, *Professional Standards*).

13.137 The following are examples of substantive procedures for auditing the fiduciary net position component of net pension liability for single employers when the employer auditor is performing all the substantive procedures:

a. Obtaining a detailed schedule of fiduciary net position for the plan as of the measurement date that includes all plan assets, deferred outflows of resources, liabilities, and deferred inflows of resources and performing the following:

   i. Performing substantive procedures on the elements similar to those performed for a single-employer plan as described in part I of this chapter

   ii. Reconciling to fiduciary net position used by the actuary in the calculation of the net pension liability *b.* Obtaining a detailed schedule of changes in fiduciary net position for the plan that includes all additions and deductions for the measurement period and performing the following:

   i. Agreeing beginning fiduciary net position to the prior year audited financial statements

   ii. Performing substantive procedures on the relevant elements of additions (for example, contributions and investment income) and deductions (for example, benefit payments and administrative expenses) during the measurement period similar to those performed for a single-employer plan as described in part I of this chapter

13.138 The following are examples of substantive procedures for auditing the fiduciary net position component of net pension liability for single employers when the employer auditor is obtaining audited plan financial statements (audited by another auditor) and is performing additional procedures on components of changes in fiduciary net position:

a. Obtaining audited plan financial statements

b. Evaluating whether the plan auditor's report is adequate and appropriate for the employer auditor's purposes

c. Agreeing beginning fiduciary net position for the employer to the prior year audited financial statements

d. Verifying the completeness and accuracy of the employer and employee contributions attributed to the employer

e. Performing analytical procedures over benefit payments by developing an expectation based on prior year benefit payments adjusted for changes in employer census data

f. Performing analytical procedures on investment income and administrative expense by developing an expectation based on expected return on average investments and the prior year's administrative expenses adjusted for changes in number of participants

g. Recomputing ending fiduciary net position based on its elements

h. Reconciling to fiduciary net position used by the actuary in the calculation of the net pension liability

i. Agreeing the fiduciary net position component of the net pension liability disclosed in the notes to the plan financial statements to that reported in the plan statement of fiduciary net position

13.139 The following are examples of substantive procedures for auditing the net pension liability for single employers when plan management prepares a schedule of pension amounts that includes total pension liability, fiduciary net position, and net pension liability, for which the plan's management engages its auditor to obtain reasonable assurance and report on net pension liability in accordance with AU-C section 805:

a. Evaluating whether the plan auditor's report on the schedule of pension amounts is adequate and appropriate for the employer auditor's purposes

b. Evaluating whether the plan auditor has the necessary competence and objectivity for the employer auditor's purposes

Emphasis Point

The employer auditor would also review the plan auditor's report and any related opinion modifications and assess other matters discussed in the report.

Fiduciary Net Position (Component of Net Pension Liability)—Agent Employers

13.140 The following are examples of substantive procedures for auditing the fiduciary net position component of net pension liability for agent employers based on information obtained from the plan (see recommendations discussed in appendix A):

a. Obtaining an audited schedule of changes in fiduciary net position by employer from the plan for the measurement period and performing the following procedures on amounts specific to the employer:

   i. Agreeing beginning fiduciary net position for the employer to the prior year audited financial statements

   ii. Verifying the completeness and accuracy of the employer and employee contributions attributed to the employer

   iii. Performing analytical procedures over benefit payments by developing an expectation based on prior year benefit payments adjusted for changes in employer census data

   iv. Performing analytical procedures on investment income and administrative expense by developing an expectation based on total investment income and administrative expense for the plan as a whole multiplied by the employer's relative percentage of fiduciary net position

   v. Recomputing ending fiduciary net position

b. Determining whether the plan engaged an auditor to opine on the schedule of changes in fiduciary net position by employer either through (i) an opinion on the schedule as a whole combined with a type 2 SOC 1 report on the controls over the calculation and allocation of additions and deductions to employer accounts or (ii) an opinion on each employer column in the schedule

c. Evaluating whether the plan auditor's report and accompanying schedule are adequate and appropriate for the employer auditor's purposes

d. Reconciling totals in the schedule of pension amounts in paragraph 13.140*a* to those reported in the audited plan financial statements

Emphasis Point

Before using the work of the plan auditor as evidence, regardless of whether the plan auditor opined on the schedule of changes in fiduciary net position as a whole with a type 2 SOC 1 report or on each employer column, the employer auditor should evaluate whether the plan auditor's report and accompanying schedule are adequate and appropriate for the employer auditor's purposes. For purposes of this evaluation, the employer auditor may review the plan auditor's report and any related opinion modifications and assess other matters discussed in the report. If a type 2 SOC 1 report is issued, employer auditors should apply the guidance in AU-C section 402 to properly utilize the report. Paragraph .13*a* of AU-C section 402 requires when determining the sufficiency and appropriateness of the audit evidence provided by a type 2 SOC 1 report, the employer auditor should be satisfied that the auditor providing the type 2 SOC 1 report is competent and independent from the plan.

Deferred Outflows of Resources and Deferred Inflows of Resources (Single and Agent Employers)

13.141 The following are examples of substantive procedures for auditing deferred outflows of resources and deferred inflows of resources for single and agent employers:

a. Obtaining a detailed schedule of deferred outflows of resources and deferred inflows of resources by type and period for the employer and performing the following:

  i. Agreeing recognition (amortization) schedules and recognition (amortization) periods for prior period deferral amounts to prior year working papers and audited financial statements, if applicable

  ii. Recalculating the current year gross incremental deferrals for differences between actual and expected experience and changes in assumptions based on information in the actuarial valuation report used to measure the net pension liability

  iii. Recalculating the current year gross incremental deferral for the difference between projected and actual earnings on pension plan investments for the measurement period

  iv. Recalculating the recognition (amortization) amount for the current period incremental deferrals for differences between actual and expected experience and changes in assumptions by dividing the gross incremental deferrals by the current year amortization period

  v. Recalculating the recognition (amortization) amount for the current period deferral for differences between projected and actual earnings on pension plan investments by dividing the gross incremental deferral by five (years)

  vi. Verifying contributions made after the measurement date and before the employer's year-end and comparing to the amount reported as deferred outflows of resources

  vii. Recalculating the mathematical accuracy of the total deferred outflows of resources and deferred inflows of resources by type as of the measurement date and the total recognition (amortization) for measurement period based on the components tested in procedures described in items *a*(i)–(vi)

Emphasis Point

If pension amounts are allocated between the primary government and component units or to proprietary and fiduciary funds using the allocation methodology for employers participating in a cost-sharing plan, there may be two additional types of deferrals related to (*a*) changes in proportion and (*b*) differences between actual contributions and the proportionate share of total contributions from all employers (see exhibit 13-4). Paragraph 13.179*k* provides suggested procedures on employer-specific deferred outflows of resources and deferred inflows of resources specific to cost-sharing employers that may be adapted for this purpose.

Considerations for Pensions Not Administered Through a Qualifying Trust

The previous examples of substantive procedures for auditing deferred outflows of resources and deferred inflows of resources have the following modifications for pensions not administered through a qualifying trust:

- Paragraph 13.141*a*(iii) and 13.141*a*(v): Delete these procedures because there are no deferrals related to investment earnings.
- Paragraph 13.141*a*(vi): Replace this procedure with: "Verifying amounts paid by the government for pensions as the benefits come due after the measurement date and before the employer's year-end and comparing to the amount reported as deferred outflows of resources."

Pension Expense (Single and Agent Employers)

13.142 The following are examples of substantive procedures for auditing pension expense for single and agent employers:

a. Obtaining a detailed schedule of pension expense for the measurement period

b. Comparing total service cost to the actuarial valuation used to measure the total pension liability

c. Comparing employee contributions to audited plan financial statements, if applicable, or contributions tested in conjunction with the substantive procedures described in paragraph 13.137 that correspond to the measurement period

d. Recalculating interest on total pension liability by multiplying beginning total pension liability, adjusted for service cost and actual benefit payments, by the discount rate

e. Verifying changes in benefit terms to the actuarial valuation report and procedures performed related to the total pension liability in paragraph 13.134

f. Comparing plan administrative costs to audited plan financial statements, if applicable, or administrative costs tested in conjunction with the substantive procedures described in paragraph 13.137 that correspond to the measurement period

g. Recalculating projected earnings on plan investments by multiplying beginning plan fiduciary net position, adjusted for contributions, actual benefit payments, and actual administrative expenses, by the long-term expected rate of return on plan investments

> ***Emphasis Point***
>
> Projected earnings on pension plan investments should consider changes in invested amounts and should be calculated as the return that actual invested amounts would have earned at the assumed rate of return over the measurement period. Paragraph 30 of GASB Statement No. 68 requires that the long-term expected rate of return should be net of investment expense, but not net of administrative expense, and should reflect the expectation of the rate as of the beginning of the measurement period.

h. Reconciling amounts of deferred outflows of resources and deferred inflows of resources recognized as pension expense based on procedures performed in paragraph 13.141

i. Recalculating the mathematical accuracy of total pension expense based on the individual components

> ***Considerations for Pensions Not Administered Through a Qualifying Trust***
>
> The previous examples of substantive procedures for auditing pension expense has the following modification for pensions not administered through a qualifying trust:
>
> - Paragraph 13.142*g*: Delete this procedure because there are no plan investments.

Part III—Employer Accounting, Financial Reporting, and Auditing Considerations Cost-Sharing Employers

> ***Emphasis Point***
>
> Part III of this chapter addresses specific accounting and auditing considerations for employers participating in cost-sharing multiple-employer defined benefit pension plans in accordance with GASB Statement No. 68. Part III makes reference to suggested solutions to cost-sharing multiple-employer plans discussed in appendix B. Although the guidance in appendix B is integral to the audit of the employer's financial statements, the appendix is an *other auditing publication* and is nonauthoritative.

Accounting and Financial Reporting Considerations

Recognition and Measurement in Financial Statements Prepared Using Economic Resources Measurement Focus and Accrual Basis of Accounting (No Special Funding Situation)

13.143 Governments (employers) that provide defined benefit pensions through a cost-sharing multiple-employer (cost-sharing) plan that is administered through a qualifying trust are required to report their proportionate shares of the plan's collective net pension liability, pension expense, and certain deferred outflows of resources and deferred inflows of resources (pension amounts) in their financial statements in accordance with GASB Statement No. 68.

Proportionate Share of Collective Net Pension Liability[19]

13.144 Paragraph 48 of GASB Statement No. 68, as amended, requires that a liability be recognized for the employer's proportionate share of the collective net pension liability, measured as of a date (measurement date) no earlier than the end of the employer's prior fiscal year, consistently applied from period to period.

> ***Emphasis Point***
>
> Based on the need for information from the plan, the employer will likely select a measurement date that coincides with the fiscal year-end of the plan.

13.145 Paragraph 48 of GASB Statement No. 68, as amended, requires that the employer's proportionate share of the collective net pension liability be measured by

a. determining the employer's proportion—a measure of the proportionate relationship of (i) the employer (and, to the extent associated with the employer, nonemployer contributing entities, if any, that provide support for the employer but that are not in a special funding situation) to (ii) all employers and all nonemployer contributing entities. The basis for the employer's proportion should be consistent with the manner in which contributions to the pension plan, excluding those to separately finance specific liabilities of an individual employer to the pension plan, are determined. The use of the employer's projected long-term contribution effort to the pension plan (including that of nonemployer contributing entities that provide support for the employer but that are not in a special funding situation) as compared to the total projected long-term contribution effort of all employers and all nonemployer contributing entities to determine the employer's proportion is encouraged.

b. multiplying the collective net pension liability by the employer's proportion calculated in item *a*.

13.146 Paragraph 49 of GASB Statement No. 68 states that to the extent that different contribution rates are assessed based on separate relationships that constitute the collective net pension liability (for example, separate rates are calculated based on an internal allocation of liabilities and assets for different classes or groups of employees), the determination of the employer's proportionate share of the collective net pension liability should be made in a manner that reflects those separate relationships.

13.147 Paragraph 50 of GASB Statement No. 68 requires that the employer's proportion be established as of the measurement date, unless the

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[19] In this guide, references to a net pension liability also apply to situations in which the fiduciary net position exceeds the total pension liability resulting in a net pension asset.

employer's proportion is actuarially determined, in which case, a proportion established at the date of the actuarial valuation used to determine the collective net pension liability may be used.

Emphasis Point

Paragraph 48 of GASB Statement No. 68, as amended, requires that the basis for the employer's proportion be consistent with the manner in which contributions to the plan are determined. Although GASB Statement No. 68 encourages an allocation method based on an employer's projected long-term contribution effort to the plan as compared to the total projected long-term contribution efforts of all employers contributing to the plan (that is, the actuarial method), the standard allows for other allocation methods to be used, including allocations based on historical measures, such as actual contributions or pensionable wages. Allocations based on historical measures are likely to be more easily substantiated than the actuarial method. However, the use of such a historical measure may not be appropriate in certain circumstances.

Collective Pension Expense, Deferred Outflows of Resources, and Deferred Inflows of Resources

13.148 Paragraph 53 of GASB Statement No. 68 requires that pension expense, as well as deferred outflows of resources and deferred inflows of resources related to pensions, be recognized for the employer's proportionate share of collective pension expense and collective deferred outflows of resources and deferred inflows of resources related to pensions. The employer's proportionate share should be determined using the employer's proportion of the collective net pension liability.

Change in Proportion

13.149 In accordance with paragraph 54 of GASB Statement No. 68, if there is a change in the employer's proportion of the collective net pension liability since the prior measurement date, the net effect of that change on the employer's proportionate share of the collective net pension liability and collective deferred outflows of resources and deferred inflows of resources related to pensions, determined as of the beginning of the measurement period, it should be recognized in the employer's pension expense, beginning in the current reporting period, using a systematic and rational method over a closed period.

13.150 For this purpose, the length of the expense recognition period should be equal to the average of the expected remaining service lives of all employees that are provided with pensions through the pension plan (active employees and inactive employees) determined as of the beginning of the measurement period. The amount not recognized in the employer's pension expense should be reported as a deferred outflow of resources or deferred inflow of resources.

Contributions During the Measurement Period

13.151 Paragraph 55 of GASB Statement No. 68 states that for contributions to the pension plan other than those to separately finance specific liabilities of an individual employer or nonemployer contributing entity to the pension plan, the difference during the measurement period between both of the following should be recognized in the employer's pension expense, beginning in the current reporting period, using a systematic and rational method over a closed period:

a. The total amount of such contributions from the employer (and amounts associated with the employer from nonemployer contributing entities that are not in a special funding situation)

b. The amount of the employer's proportionate share of the total of such contributions from all employers and all nonemployer contributing entities

13.152 For this purpose, the length of the expense recognition period should be equal to the average of the expected remaining service lives of all employees that are provided with pensions through the pension plan (active employees and inactive employees) determined as of the beginning of the measurement period. The amount not recognized in the employer's pension expense should be reported as a deferred outflow of resources or deferred inflow of resources related to pensions.

13.153 Paragraph 56 of GASB Statement No. 68 states that for contributions to the pension plan to separately finance specific liabilities of the individual employer to the pension plan, the difference during the measurement period between both of the following should be recognized in the employer's pension expense:

a. The amount of such contributions from the employer (and amounts associated with the employer from nonemployer contributing entities that are not in a special funding situation).

b. The amount of the employer's proportionate share of the total of the contributions in item *a*, determined using the employer's proportion of the collective net pension liability.

Employer Contributions After Measurement Date

13.154 Paragraph 57 of GASB Statement No. 68, as amended, requires contributions to the pension plan from the employer subsequent to the measurement date of the net pension liability and before the end of the reporting period be reported as a deferred outflow of resources related to pensions.

> ***Emphasis Point***
>
> GASB IG 2015-1 question 5.169.1 requires the deferred outflow of resources reported by an employer for contributions made after the measurement date and before the end of the employer's financial reporting period to include contributions made by the employer during its fiscal year that will be reflected in the net pension liability in the next measurement period—that is, the amount of contributions through the end of the employer's fiscal year to be recognized by the pension plan on the accrual basis of accounting in the next measurement period.

Collective Net Pension Liability

13.155 Paragraph 59 of GASB Statement No. 68 requires that the collective net pension liability be measured as the portion of the actuarial present value of projected benefit payments that is attributed to past periods of employee service (total pension liability) for the plan as a whole, net of the pension plan's fiduciary net position. The assumptions used in measuring the total pension liability should be the same as those used for the plan, as discussed in part I. The pension plan's fiduciary net position component of net pension liability should be determined using the same valuation methods that are used by the pension plan for purposes of preparing its statement of fiduciary net position.

13.156 When the underlying actuarial valuation is as of a date prior to the required measurement date, paragraph 60 of GASB Statement No. 68 requires the use of update procedures to roll forward the valuation to the measurement date for the employer's reporting. The employer may roll forward an actuarial valuation performed as of a date no more than 30 months and 1 day earlier than the employer's most recent fiscal year-end to the employer's measurement date. Professional judgment should be used to determine the specific update procedures to be used, and consideration should be given to whether a new actuarial valuation is needed as discussed in paragraph 60.

Emphasis Point

Employers should work collaboratively with the plan to determine the timing and frequency of actuarial valuations, especially if the plan chooses to perform actuarial valuations on a biennial basis. GASB Statement No. 68 requires the total pension liability for employers be determined by an actuarial valuation performed as of a date no more than 30 months and 1 day from the employer's most recent fiscal year-end. It is possible for a plan to be in compliance with the requirements of GASB Statement No. 67 (for example, actuarial valuation within 24 months of the plan's fiscal year-end), but the date of that valuation, could be greater than 30 months and 1 day from the employer's most recent fiscal year-end, which would not be in compliance with the requirements of GASB Statement No. 68.

13.157 The collective pension expense and collective deferred outflows of resources and deferred inflows of resources related to pensions that are required to be recognized by an employer primarily result from changes in the components of the collective net pension liability—that is, changes in the collective total pension liability and in the pension plan's fiduciary net position. Most changes in the collective net pension liability are included in the collective pension expense in the period of the change. For example, changes in the collective total pension liability resulting from current-period service cost, interest on the collective total pension liability, and changes of benefit terms are required to be recognized as collective pension expense in the current reporting period. Projected earnings on the pension plan's investments also are required to be included in the determination of the collective pension expense in the current reporting period. Exhibit 13-4 of this chapter provides a summary of the various components of pension expense.

13.158 Paragraph 71 of GASB Statement No. 68 states that changes in the collective net pension liability should be included in the collective pension expense in the current measurement period except as indicated in the following:

a. Each of the following should be recognized in collective pension expense, beginning in the current measurement period, using a systematic and rational method over a closed period equal to the average of the expected remaining service lives of all employees that are provided with pensions through the pension plan (active employees and inactive employees) determined as of the beginning of the measurement period:

   i. Differences between expected and actual experience with regard to economic or demographic factors (differences between expected and actual experience) in the measurement of the total pension liability

   ii. Changes of assumptions about future economic or demographic factors or of other inputs (changes of assumptions or other inputs)

   The portion of (i) and (ii) not recognized in collective pension expense should be included in collective deferred outflows of resources or deferred inflows of resources related to pensions.

b. The difference between projected and actual earnings on pension plan investments should be included in collective pension expense using a systematic and rational method over a closed five-year period, beginning in the current measurement period. The amount not included in collective pension expense should be included as deferred outflows of resources or deferred inflows of resources related to pensions. Collective deferred outflows of resources and deferred inflows of resources arising from differences between projected and actual pension plan investment earnings in different measurement periods should be aggregated and included as a net deferred outflow of resources related to pensions or a net deferred inflow of resources related to pensions.

c. Contributions to the pension plan from employers or nonemployer contributing entities should not be included in collective pension expense.

Allocation of Pension Amounts to Funds or Departments, or Both

13.159 GASB Statement No. 68 does not establish specific requirements for allocation of the net pension liability or other pension-related amounts to individual funds or departments. However, GASB IG 2015-1 question 5.129.1 states

> For proprietary and fiduciary funds, consideration should be given to NCGA Statement 1, *Governmental Accounting and Financial Reporting Principles*, paragraph 42, as amended, which requires that long-term liabilities that are directly related to and expected to be paid from those funds be reported in the statement of net position or statement of fiduciary net position, respectively.

Accordingly, when governments allocate pension amounts to funds or departments, or both, the allocation methodology described for employers participating in cost-sharing plans would be appropriate for such purpose. Such an allocation approach may result in the recognition of additional deferred outflows of resources or deferred inflows of resources related to changes in proportion from year to year.

Recognition and Measurement in Financial Statements Prepared Using Current Financial Resources Measurement Focus and Modified Accrual Basis of Accounting

13.160 In financial statements prepared using the current financial resources measurement focus and modified accrual basis of accounting, paragraph 73 of GASB Statement No. 68 specifies that a net pension liability should be recognized to the extent the liability is normally expected to be liquidated with expendable available financial resources. Pension expenditures should be recognized equal to the total of (*a*) amounts paid by the employer to the pension plan and (*b*) the change between the beginning and ending balances of amounts normally expected to be liquidated with expendable available financial resources. Net pension liabilities are normally expected to be liquidated with expendable available financial resources to the extent that benefit payments have matured—that is, benefit payments are due and payable, and the pension plan's fiduciary net position is not sufficient for payment of those benefits.

Note Disclosures and Required Supplementary Information

13.161 Paragraphs 76–80 of GASB Statement No. 68 address the note disclosures to the financial statements of cost-sharing employers. The following are among the required disclosures:

- Plan description
- Employer's proportionate share (amount) of collective net pension liability.
- Employer's proportion (percentage) of collective net pension liability (including the basis on which it was determined) and change in its proportion since prior measurement date
- Significant assumptions used to measure total pension liability, including inflation, salary changes, discount rate, and mortality
- Measurement date of collective net pension liability and date of actuarial valuation on which the total pension liability is based
- Information about plan fiduciary net position

Emphasis Point

Paragraph 79 of GASB Statement No. 68 requires note disclosures, including information about the plan's assets, deferred outflows of resources, liabilities, deferred inflows of resources, and fiduciary net position (that is, condensed financial information of the plan). However, if (*a*) a financial report that includes disclosure about the elements of the pension plan's basic financial statements is available on the Internet, either as a stand-alone financial report or included as a fiduciary fund in the financial report of another government and (*b*) information is provided about how to obtain the report, reference may instead be made to the other report for these disclosures. In this circumstance, other specific disclosures apply as discussed in paragraph 79.

- Amount of pension expense recognized by employer in reporting period

- Employer's balances of deferred outflows of resources and deferred inflow of resources related to pensions by type

13.162 In addition, cost-sharing employers have to present certain 10-year schedules of RSI[20] and related notes as discussed in paragraphs 81–82 of GASB Statement No. 68, as amended, including information on the employer's proportionate share (amount) of the collective net pension liability and information on contributions.

Special Funding Situations

13.163 In GASB Statement No. 68, *special funding situations* are defined as circumstances in which a nonemployer entity is legally responsible for making contributions directly to a pension plan that is used to provide pensions to the employees of another entity or entities and either of the following criteria is met: (*a*) the amount of contributions for which the nonemployer entity is legally responsible is not dependent upon one or more events unrelated to pensions or (*b*) the nonemployer is the only entity with a legal obligation to make contributions directly to a pension plan.

13.164 An employer that has a special funding situation for defined benefit pensions is required to recognize a pension liability and deferred outflows of resources and deferred inflows of resources related to pensions with adjustments for the involvement of nonemployer contributing entities. The employer is required to recognize its proportionate share of the collective pension expense, as well as additional pension expense and revenue related to the expense recognized by the nonemployer contributing entities. The employer is required to disclose in the notes to the financial statements information about the amount of support provided by nonemployer contributing entities and present similar information about the involvement of those entities in the 10-year schedules of RSI. See paragraphs 92–96 of GASB Statement No. 68, as amended, for specific accounting and disclosure requirements related to special funding situations for cost-sharing employers.

13.165 The recognition and measurement of liabilities, deferred outflows of resources and deferred inflows of resources, and expenses by a governmental nonemployer contributing entity in a special funding situation for defined benefit pensions is similar to that of cost-sharing employers. See paragraphs 97–117 of GASB Statement No. 68, as amended, for specific accounting and disclosure requirements related to special funding situations for nonemployer contributing entities.

Auditing Considerations for Cost-Sharing Employers

13.166 This section of the chapter discusses considerations, including describing the relevant assertions when auditing the pension information included in the employer's financial statements. This section does not include all risks or procedures that could apply to such audits in accordance with generally accepted auditing standards; instead, it focuses on specific considerations for testing certain financial statement elements of the employer's financial statements affected by defined benefit pension plans, including net pension

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[20] See footnote 15.

liability, deferred outflows of resources, deferred inflows of resources, and pension expense. The example substantive audit procedures are not considered required procedures, nor are they all-inclusive.

Determining Audit Strategy

13.167 It is important to note that regardless of the type of plan, the plan is not considered a component of the employer for purposes of AU-C section 600, as discussed in Interpretation No. 1 of AU-C section 600 (see following emphasis point). Therefore, the employer auditor is solely responsible for determining the sufficiency and appropriateness of audit evidence necessary to reduce audit risk to an appropriately low level for the pension amounts in the audit of the employer's financial statements. That is, the audited financial statements of the plan will not, by themselves, provide the employer auditor sufficient appropriate audit evidence to support the components of net pension liability (that is, total pension liability and plan fiduciary net position). Absent additional evidence obtained, the employer auditor would not likely be able to accumulate sufficient appropriate audit evidence to support the pension amounts and disclosures in the employer's financial statements.

Emphasis Point

AU-C Section 9600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors): Auditing Interpretations of Section 600*

1. *Auditor of Participating Employer in a Governmental Pension Plan*

.01 *Question*—Many governmental entities (employers) provide pension benefits to their employees through governmental pension plans. In order to report pension amounts in accordance with GASB Statement No. 68, employers obtain certain information (for example, net pension liability) from the governmental pension plan. In this circumstance, is the governmental pension plan considered a component of the employer for purposes of section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*?

.02 *Interpretation*—No. In this circumstance, a governmental pension plan is not a component of the employer for purposes of section 600. Accordingly, it would not be appropriate for an employer auditor to make reference to the audit report of the governmental pension plan auditor.

13.168 Determining the audit strategy for the pension information in the employer financial statements requires the auditor to understand the type of plan (that is, single-employer, agent, or cost-sharing, as discussed in paragraph 13.08) and what activities the various parties perform (for example, plan or employer). Example activities include investing and holding plan assets, maintaining records, receiving contributions, and disbursing benefits. In determining what activities are performed by the various parties, it is important to understand the governance structure of both the plan and the employer.

13.169 Each cost-sharing employer will be challenged about how to obtain all information to support its proportionate share of collective pension amounts reported in the employer's financial statements (that is, the collective net pension liability, deferred outflows of resources, deferred inflows of resources, and pension expense). The employer's proportionate share of the collective pension amounts is a measure of the proportionate relationship of the employer to all employers and nonemployer contributing entities.

13.170 Similarly, employer auditors will be challenged in terms of obtaining sufficient appropriate evidence regarding the pension amounts included in employer financial statements. AU-C section 500 states that the objective of the auditor is to design and perform audit procedures that enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.

13.171 Appendix B provides a two-part approach to address the challenges of employers and their auditors. The first part addresses employer allocations. The second part addresses a method to obtain reasonable assurance on the total net pension liability, total deferred outflows of resources, total deferred inflows of resources, and total pension expense for the sum of all participating entities. Appendix B provides detailed explanations and illustrations.

13.172 The substantive audit procedures included in this chapter for cost-sharing employers assumes that the cost-sharing plans provide employers with the recommended information and related audit reports discussed in appendix B.

Emphasis Point

In accordance with Interpretation No. 2, "Auditor of Participating Employer in a Governmental Cost-Sharing Multiple-Employer Pension Plan," of AU-C section 500 (AICPA, *Professional Standards*, AU-C sec. 9500 par. .23–.29), it is important for employer auditors to understand that obtaining the audited plan financial statements and additional unaudited information provided by the plan's management to calculate the employer's net pension liability will likely not provide sufficient appropriate audit evidence to support the relevant assertions in the employer's financial statements.

AU-C Section 9500, *Audit Evidence: Auditing Interpretations of AU-C Section 500*

2. Auditor of Participating Employer in a Governmental Cost-Sharing Multiple-Employer Pension Plan

.23 *Question*—GASB Statement No. 68 requires governmental entities (employers) participating in governmental cost-sharing multiple-employer pension plans (cost-sharing plan or plan) to present certain pension amounts in employer financial statements that are calculated by the plan or its actuary. Such amounts are based, in part, on records maintained only by the plan.

.24 Do the audited financial statements of the plan prepared in accordance with generally accepted accounting principles (GAAP) and additional unaudited information provided by the plan's management necessary to calculate the employer's net pension liability provide the employer's auditor with sufficient appropriate audit evidence upon which to base the opinion on the affected opinion units of the governmental employer financial reporting entity?

.25 *Interpretation*—No. GASB Statement No. 67 requires only the disclosure of the collective net pension liability for all participating employers in GAAP financial statements of cost-sharing plans, not each employer's proportionate share of the collective net pension liability. Further, GAAP does not require the plan to present deferred outflows of resources or deferred inflows of resources by category, pension expense, or each participating employer's share of collective pension amounts. Unaudited information provided by the plan's management to the employers to support allocations or pension amounts that has not been subjected to further audit procedures beyond those performed in the audit of the basic plan financial statements would not constitute sufficient appropriate audit evidence to support the relevant assertions in the employer's financial statements related to the pension amounts, including required disclosures.

.26 Absent additional audit evidence from the cost-sharing plan (for example, auditor's opinions on the schedule of employer allocations and certain key elements including net pension liability, total deferred outflows of resources, total deferred inflows of resources, and total pension expense in a schedule of pension amounts), the employer auditor would not likely be able to accumulate sufficient appropriate audit evidence to support the pension amounts and disclosures in the employer's financial statements. When pension amounts are material to one or more applicable opinion units of the employer's financial statements and the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements of those opinion units are free from material misstatement, the auditor should modify the audit opinion pursuant to section 705.

.27 *Question*—A plan has engaged its auditor to audit and report on the schedule of employer allocations and certain key elements including net pension liability, total deferred outflows of resources, total deferred inflows of resources, and total pension expense in a schedule of pension amounts, as described in the AICPA's State and Local Governments Expert Panel white paper *Governmental Employer Participation in Cost-Sharing Multiple-Employer Plans: Issues Related to Information for Employer Reporting*.[21] May an employer auditor use the plan auditor's report as evidence for the audit of the employer's financial statements?

.28 *Interpretation*—Yes. The employer auditor is solely responsible for the audit of the employer's financial statements and, therefore, is responsible for determining the sufficiency and appropriateness of audit evidence necessary to reduce audit risk to an appropriately low level. Nevertheless, the employer auditor may use the plan auditor's report on the schedules as evidence that the

[21] The contents of the AICPA's State and Local Governments Expert Panel white paper, *Governmental Employer Participation in Cost-Sharing Multiple-Employer Plans: Issues Related to Information for Employer Reporting*, are included in appendix B to this chapter.

that the pension amounts allocated to the employer and included in the employer's financial statements are not materially misstated.

.29 Before using the report of the plan auditor as evidence, the employer auditor should evaluate whether the plan auditor's report and accompanying schedules are adequate and appropriate for the employer auditor's purposes. For example, the employer auditor may review the plan auditor's report and any related opinion modifications and assess other matters discussed in the report. Additionally, the employer auditor should evaluate whether the plan auditor has the necessary competence and independence for the employer auditor's purposes. Further, the employer auditor has a responsibility to verify and recalculate amounts specific to the applicable employer, including the employer amount used in the allocation percentage (that is, the numerator of the calculation), to recalculate the allocation percentage for the employer, and to recalculate the pension amounts allocated to the employer based on the allocation percentage.

Census Data

13.173 As discussed in paragraphs 13.11–.15, certain financial statement elements of cost-sharing employers that participate in defined benefit pension plans (that is, net pension liability, deferred outflows of resources, deferred inflows of resources, and pension expense) are dependent on demographic data (census data) of the members. The employer auditor's consideration of the relevant financial statement assertions that are dependent on census data begins with understanding the processes and internal control used by the employer and the plan to support the completeness and accuracy of the significant elements of census data that are provided to the actuary. In a cost-sharing plan, individual employer census data affects the collective pension amounts reported by the plan. Certain census data elements, such as contributions, directly affects the individual employer's proportionate share if used as the basis for allocation. Other census data elements affect the plan as a whole and are attributable to individual employers to the extent they affect the collective pension amounts to be allocated.

13.174 *Significant elements of census data* are those elements that, either individually or when combined with other elements, could result in a material misstatement to one or more elements of the employer's financial statements (that is, net pension liability, deferred outflows of resources, deferred inflows of resources, and pension expense). Significant elements of census data may include some or all of the following:

a. Name

b. Social Security number

c. Date of birth

d. Date of hire

e. Marital status

f. Pensionable wages

g. Service credits (periods of time worked)

h. Class of employee

i. Position or job code (or both)

j. Contributions

k. Gender

l. Date of termination or retirement

m. Spouse's date of birth

n. Employment status (active, inactive entitled to but not receiving benefits, retired).

The significance of some of these elements, all of these elements, or additional elements to any plan will be based on the impact that a particular census data element has on the measurement of a particular financial statement element. In a cost-sharing plan, as part of determining the significant elements of census data, it is important for the employer auditor to understand how the individual elements of census data impact the plan as a whole and the individual employers. Significant elements of census data from the perspective of the employer auditor include those elements that affect the pension amounts allocated to that specific employer. Employer auditors will obtain an understanding of the significant elements of census data that, either individually or when combined with other elements, could result in a material misstatement to the employer's financial statements.

13.175 The underlying records that support the census data for cost-sharing plans are typically maintained by different parties. The underlying records of active members are typically maintained by the employers. The underlying records of plan members who are no longer employed by the employers (that is, inactive members) are typically maintained by the plan. The underlying records of active members (of the applicable individual employer) maintained by the employer for purposes of testing the *significant elements of census data* that were reported to the plan during the period could be tested by the employer auditor, but access to information for the census data maintained by the plan, as well as census data related to active plan members of other cost-sharing employers, necessitates additional support from the plan and plan auditor.

13.176 The employer auditor performs procedures to test the significant elements of census data reported to the plan, whereas the plan auditor performs procedures to test the significant elements of census data maintained by the plan as discussed in part I. The plan auditor performs procedures to test census data reported to the plan by the employers. The substantive procedures over census data (for both the employer and the plan auditor) are ordinarily based on a concept that focuses on testing incremental changes (see paragraph 13.15) to the census data file since the prior actuarial valuation, assuming (*a*) the prior year plan financial statements were audited, (*b*) there were no modifications to the auditor's report in the prior year related to census data, and (*c*) the auditor has concluded there is no significant risk of material misstatement due to incomplete or inaccurate census data from prior years. These procedures would ordinarily cover the census data reported to the plan during (1) the year immediately preceding the actuarial valuation when the actuarial valuation is performed on an annual basis or (2) the two-year period immediately preceding the actuarial valuation when the actuarial valuation is performed on a biennial basis.

Net Pension Liability, Deferred Outflows of Resources and Deferred Inflows of Resources, and Pension Expense for Cost-Sharing Employers

Relevant Assertions

13.177 The relevant assertions relating to net pension liability, deferred outflows of resources, deferred inflows of resources, and pension expense for cost-sharing employers include the following:

- *a.* Member census data reported to the plan is complete and accurate.
- *b.* Member census data accumulated and maintained by the plan is complete and accurate.
- *c.* Actuarial assumptions used in computing the total pension liability are in accordance with GASB Statement No. 68 and the Actuarial Standards of Practice.
- *d.* The employer's proportionate share of the collective pension amounts, including net pension liability, deferred outflows of resources and deferred inflows of resources, and pension expense have been properly determined and recorded in the financial statements in accordance with GASB Statement No. 68 and in the proper period.
- *e.* The employer's deferred outflows of resources and deferred inflows of resources for contributions made after the measurement date, changes in proportion, and differences between the employer's actual contributions and its proportionate share of all employer contributions have been properly determined and recorded in the financial statements in accordance with GASB Statement No. 68 and in the proper period and are properly disclosed.

Examples of Identified Risks of What Can Go Wrong at the Relevant Assertion Level

13.178 The following are examples of identified risks of what can go wrong at the relevant assertion level relating to net pension liability, deferred outflows of resources, deferred inflows of resources, and pension expense for cost-sharing employers:

- *a.* Census data reported by the employer to the plan is not accurate and complete.
- *b.* The actuary uses inappropriate assumptions or actuarial methods that are not in conformity with GASB Statement No. 68 and the Actuarial Standards of Practice, causing errors in the computation of total pension liability.
- *c.* The collective pension amounts, including net pension liability, deferred outflows of resources and deferred inflows of resources, and pension expense have not been properly determined in accordance with GASB Statement No. 68.
- *d.* The employer's proportionate share of the collective pension amounts is not consistent with the manner in which the employer's contributions are made to the plan.
- *e.* The plan auditor's report and accompanying schedule of employer allocations and schedule of pension amounts (see appendix B) are not adequate or appropriate for the employer auditor's purposes (for

example, opinion modification, opinion on the schedule as a whole and not the individual elements, employer or employer auditor, or both, not named in the report as a specified user).

f. The plan auditor engaged to report on the schedule of employer allocations and schedule of pension amounts (see appendix B) does not have the necessary competence and objectivity for the employer auditor's purposes.

g. The amounts included in the schedule of employer allocations prepared by the plan (see appendix B) specific to the employer, including the employer amount used in the allocation percentage (that is, the numerator of the calculation), are not accurate.

h. The amounts included in the schedule of pension amounts prepared by the plan (see appendix B) specific to the employer are not accurate.

i. The employer-specific deferred outflows of resources and deferred inflows of resources (including contributions made after the measurement date, changes in proportion, and differences between the employer's actual contributions and its proportionate share of total employer contributions) have not been properly determined in accordance with GASB Statement No. 68.

Example Audit Procedures to Consider

13.179 The following are examples of substantive procedures for auditing net pension liability, deferred outflows of resources and deferred inflows of resources, and pension expense for cost-sharing employers based on the suggested two-part approach included in appendix B (excluding census data, which are discussed in paragraph 13.180):

a. Obtaining the actuarial valuation report used to measure the collective total pension liability for the plan as of the measurement date based on GASB Statement No. 68.

> ***Emphasis Point***
>
> Plans often have different actuarial valuations performed for accounting (for example, accounting pursuant to GASB Statement No. 68) and funding (for example, actuarially determined contribution) purposes.

b. Evaluating the professional qualifications of the actuary, including his or her competence, capabilities, and objectivity as required by paragraph .08 of AU-C section 500. If the actuary is not known to the auditor, consider other factors that might provide information regarding the actuary's qualifications, such as (i) the actuary's membership in a recognized professional organization, (ii) the number and types of public pension plans served, including years of experience, and (iii) the opinion of other actuaries whom the auditor knows to be qualified regarding the actuary's professional qualifications.

c. Reading the actuarial certification for potential exclusions from the scope of the actuary's work or qualifications on the actuary's certification relating to actuarial methods, actuarial assumptions, or census data.

d. Determining whether the actuarial valuation was performed as of a date no more than 30 months and 1 day from the employer's fiscal year-end.

e. Evaluating whether the methods and assumptions used in determining the total pension liability are in accordance with GASB Statement No. 68 and Actuarial Standards of Practice and are the same as those used by the plan.

f. Obtaining the audited schedule of employer allocations and comparing and recalculating amounts specific to the employer to the employer's records.

Emphasis Point

Comparing and recalculating amounts used in the schedule of employer allocations is meant to address whether the amount or information reported to the plan that relates to the allocation was complete and accurate; whether the amount reported by the plan (numerator) agrees to the employer's records; and that the calculation is mathematically accurate.

g. Obtaining the audited schedule of pension amounts and recalculating the allocated pension amounts for the employer by multiplying the collective pension amounts for the plan by the employer's proportionate share (allocation percentage).

h. Evaluating whether the plan auditor's report on the schedule of employer allocations and the schedule of pension amounts is adequate and appropriate for the employer auditor's purposes.

Emphasis Point

If an employer makes contributions to separately finance specific liabilities of the individual employer as discussed in paragraph 13.153, such contributions may or may not be reflected in the schedule of pension amounts. If not included in the schedule, alternative evidence is necessary to substantiate the amounts.

i. Evaluating whether the plan auditor has the necessary competence and objectivity for the employer auditor's purposes.

j. Obtaining the audited plan financial statements and performing the following:

   i. Agreeing or reconciling net pension liability reported in the schedule of pension amounts in item *g* to the net pension liability disclosed in the notes to the plan financial statements

   ii. Agreeing the fiduciary net position component of the net pension liability disclosed in the notes to the plan financial statements to that reported in the plan statement of fiduciary net position

k. Obtaining a detailed schedule of employer-specific deferred outflows of resources and deferred inflows of resources by type (including contributions made after the measurement date, changes in proportion, and differences between the employer's actual contributions and its proportionate share of total employer contributions) and by period and performing the following:

i. Testing contributions made after the measurement and before the employer's year-end and comparing to the amount reported as deferred outflows of resources

ii. Agreeing recognition (amortization) schedules and recognition (amortization) periods for prior period deferral amounts to prior year working papers and audited financial statements

iii. Recalculating the current year gross incremental deferrals for changes in proportion and differences between the employer's actual contributions and its proportionate share of total employer contributions

iv. Recalculating the recognition (amortization) amount for the current period incremental deferrals for changes in proportion and differences between the employer's actual contributions and its proportionate share of total employer contributions for example, by dividing the current respective gross incremental deferrals by the current year amortization period for the plan

l. Recalculating the mathematical accuracy of the total deferred outflows of resources and deferred inflows of resource by type as of the measurement date and the total recognition (amortization) for the measurement period based on the components tested in items *g* and *k*.

m. Recalculating pension expense based on the employer's specific pension expense in the schedule of pension amounts from item *g* plus the recognition (amortization) amount of employer-specific deferred outflows of resources and deferred inflows of resources from item *k*.

Census Data

> ***Emphasis Point***
>
> As discussed in paragraph 13.176, the substantive procedures over census data (for both the employer and the plan auditor) are ordinarily based on a concept that focuses on testing incremental changes (see paragraph 13.15) to the census data file since the prior actuarial valuation, assuming (*a*) the prior year plan financial statements were audited, (*b*) there were no modifications to the auditor's report in the prior year related to census data, and (*c*) the auditor has concluded there is no significant risk of material misstatement due to incomplete or inaccurate census data from prior years. These procedures would ordinarily cover the census data reported to the plan during the year immediately preceding the actuarial valuation when the actuarial valuation is performed on an annual basis.
>
> If the plan performs biennial valuations, the census data to be tested for the 20X6 valuation would be that reported to the plan since the last valuation (that is, 24-months ending July 1, 20X6).
>
> For example, if an employer has a fiscal year-end of June 30, 20X5 and uses a measurement date of June 30, 20X4 based on an actuarial valuation that was

performed as of July 1, 20X3 and rolled forward to the measurement date of June 30, 20X4, the focus of the procedures would ordinarily be over the changes to the census data that were reported to the plan during the year ended June 30, 20X3.

Emphasis Point

Focusing on the risk of material misstatement to the employer, the employer auditor should design and perform audit procedures over the census data that are responsive to the risk of material misstatement at the assertion level. This will be dependent on both the nature of the plan and the risks at the employer level, including the employer's relative proportion of the collective pension amounts for the plan. For example, when collective pension amounts are allocated to participating employers based on the relative percentage of actual employer contributions to the plan and the employer constitutes a relatively small portion of the total plan, the employer auditor may determine that the audit procedures that are responsive to the assessed risks of material misstatement relate to the completeness and accuracy of census data that affects the calculation and reporting of the respective employer contributions. In contrast, when an employer constitutes a relatively large portion of the plan, the employer auditor may determine that the audit procedures that are responsive to the assessed risks of material misstatement relate to the completeness and accuracy of census data that affects both (1) the calculation and reporting of the respective employer contributions and (2) the collective pension liability for the plan. The employer auditor will determine the appropriate audit procedures to address these risks, which may include substantive procedures over cumulative pension reporting at the employer level or individual participant census data testing, or both.

13.180 The following are examples of substantive procedures for testing the completeness and accuracy of the census data reported to the plan (for active members) assuming certain census data elements present a potential risk of material misstatement to the employer:

a. Identifying the payroll registers and payroll cycles for all reporting units of the government

b. Obtaining the population of employer (payroll) transmission reports submitted to the plan during the period from the prior valuation to the current valuation and performing the following:

    i. Evaluating whether the population of employer (payroll) transmission reports received is complete based on an understanding of the employer's payroll registers and cycles

    ii. Selecting a sample of employer (payroll) transmission reports to verify the mathematical accuracy of reports and whether the correct contribution rates were used

c. Obtaining a list of new employees hired during the period from the prior valuation to the current valuation from the employer and performing the following procedures:

    i. Selecting a sample to determine that eligible new employees were appropriately enrolled in the plan and properly included in the employer (payroll) transmission reports

ii. For each employee selected, verifying accuracy of the significant elements of census data reported to the plan upon enrollment to the payroll and personnel records

> ***Emphasis Point***
>
> The employer auditor may need to obtain the enrollment forms or the equivalent information from the plan.

d. Obtaining a list of status changes reported to the plan during the period from the prior valuation to the current valuation (other than those reported through the employer [payroll] transmission reports) and selecting a sample to determine that they were appropriate based on the relevant plan criteria and underlying payroll and personnel records

e. Selecting a sample of active members and performing the following procedures:

> ***Emphasis Point***
>
> Consider selecting a sample from the employer's payroll registers throughout the year and a sample from the employer (payroll) transmission reports throughout the year.

i. Agreeing details included in the applicable employer (payroll) transmission report (for example, name, position or job code, periods of time worked, pensionable wages for the period, employer contribution for the period, and employee contribution for the period) to the payroll register (or vice versa), and agreeing the underlying information to the payroll and personnel records

ii. Evaluating whether the selected employee is eligible to participate in the plan based on the eligibility criteria included in the plan document (state statutes)

iii. Recalculating service credits

13.181

Appendix A—Governmental Employer Participation in Agent Multiple-Employer Plans: Issues Related to Information for Employer Reporting

Auditing guidance contained in guide appendixes is considered an *other auditing publication*. Other auditing publications have no authoritative status; however, they may help the auditor understand and apply generally accepted auditing standards.

Although the auditor determines the relevance of these publications in accordance with AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*), the auditor may presume that other auditing publications published by the AICPA that have been reviewed by the AICPA Audit and Attest Standards staff are appropriate.

Agent Employers' Recognition of Their Specific Pension Amounts [1]

A-01 An agent multiple-employer (agent) plan is one in which the employers' assets are pooled for investment purposes, but separate accounts are maintained for each individual employer. It is essentially a collection of single-employer pension plans that are commonly administered. Such plans frequently have a large number of participating employers, often in the thousands.

A-02 As discussed in part II, in accordance with GASB Statement No. 68, *Accounting and Financial Reporting for Pensions—an amendment of GASB Statement No. 27*, employers are required to recognize a liability as employees earn their pension benefits (that is, as they provide services to the government). Employers participating in agent plans report their specific pension amounts, which include net pension liability,[2] deferred outflows of resources, deferred inflows of resources, and pension expense (that is, specific pension amounts), as illustrated in exhibit A-1. To the extent that the employer's long-term obligation to provide pension benefits (that is, total pension liability) is larger than the value of the assets available in the plan to pay pension benefits (that is, fiduciary net position), there is a net pension liability.

[1] Some agent plans include *special funding situations*, which are situations in which a nonemployer entity is legally responsible for making contributions directly to a pension plan that is used to provide pensions to the employees of another entity or entities (for example, state government contributes to a local government plan). This guide does not address special funding situations. If such a situation exists, the accounting treatment for the employer would be different than that described in this guide. See GASB Statement No. 68, *Accounting and Financial Reporting for Pensions—an amendment of GASB Statement No. 27*, for more information.

[2] In this guide, references to a net pension liability also apply to situations in which the fiduciary net position exceeds the total pension liability, resulting in a net pension asset.

Employer Issues—Recognizing Their Specific Pension Amounts and Related Auditor Issues

A-03 Each employer participating in an agent plan needs to obtain all necessary information to support its specific pension amounts, including net pension liability, deferred outflows of resources, deferred inflows of resources, and pension expense. These specific pension amounts are dependent on certain accounting records maintained by the plan, the controls and processes of the plan, as well as the calculations by the plan's actuary. The employer is solely responsible for its financial statements and, therefore, employer management must establish financial reporting processes and controls over the recognition, measurement, presentation, and disclosure of its various pension amounts.

A-04 Similarly, employer auditors need to obtain sufficient appropriate audit evidence regarding the specific pension amounts included in employer financial statements. AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*), states that the objective of the auditor is to design and perform audit procedures that enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.

A-05 The following sections further describe additional considerations related to employer accounting and financial reporting related to participation in agent plans.

Limitations With the Audited Statements of the Plan

A-06 Under GASB Statement No. 67, *Financial Reporting for Pension Plans—an amendment of GASB Statement No. 25*, the financial statements of agent plans do not include the specific pension amounts required to be reported by participating employers, and these employers do not have direct access to the underlying plan records and data supporting such amounts. Additionally, the plan financial statements do not disclose actuarial information for each individual employer or the plan as a whole. Actuarial information for each employer, including census data submitted to the actuary, underpins the calculation of the employer's net pension liability.

A-07 The financial statements of agent plans only report fiduciary net position for the plan as a whole. Because fiduciary net position is a component necessary to calculate net pension liability (see exhibit A-1), employers need their specific interest in the agent plan's fiduciary net position (that is, their separate account information), which the plan is not required to report in its financial statements.

A-08 As noted in Interpretation No. 3, "Auditor of Participating Employer in a Governmental Agent Multiple-Employer Pension Plan," of AU-C section 500 (AICPA, *Professional Standards*, AU-C sec. 9500 par. .30–.36), participating employers and their auditors need information beyond what is provided in the audited financial statements of the plan to determine their specific pension amounts.

Verifying Completeness and Accuracy of Census Data

A-09 Actuarially derived pension amounts (that is, total pension liability, deferred outflows of resources, deferred inflows of resources, and pension expense) are dependent on demographic data of the plan participants, which is referred to as *census data*, as discussed in paragraphs 13.11–.15 and part II.

A-10 As discussed in part II, the agent plan and employer are almost always under different governance structures, thus, the underlying records of the census data are typically maintained by different parties. Because the census data file is an accumulation of census data information reported over numerous years that is continually adjusted by the plan based on known events, another challenge facing employers is how to determine whether census data pertaining to their inactive and retired members is complete and accurate and whether the plan has properly accumulated the census data information for active members reported to it by participating employers in the census data file provided to the actuary.

Two-Part Solution

A-11 The differences in reporting requirements for the plan compared to the employer are significant. Given the nature of the elements the employer is required to report, this guide recommends a solution to address total pension liability, deferred outflows of resources, deferred inflows of resources, and pension expense and another solution to address the employer's specific interest in the agent plan's fiduciary net position.

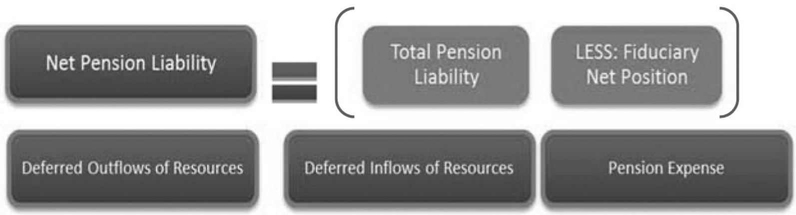

Exhibit A-1: Employer-Specific Pension Amounts

Solution for Total Pension Liability, Deferred Outflows of Resources, Deferred Inflows of Resources, and Pension Expense

Exhibit A-2: Part 1 of Solution

A-12 To obtain sufficient appropriate evidence on the employer-specific total pension liability, deferred outflows of resources, deferred inflows of resources, and pension expense (as illustrated in preceding exhibit A-2), this guide recommends the following two-part solution, which is further explained in the following text:

- The plan actuary issues a separate actuarial valuation report specific to each employer, which includes an actuarial certification addressed to employer management.
- The plan engages its auditor to issue either

— option 1: a type 2 SOC 1 report on controls over census data maintained by the plan or

— option 2: an examination engagement over selected management's assertions related to census data maintained by the plan.

A-13 The employer auditor is solely responsible for the audit of the employer's financial statements and, therefore, is responsible for determining the sufficiency and appropriateness of audit evidence necessary to reduce audit risk to an appropriately low level. The solution discussed herein may need to be tailored to fit the particular risks identified at the employer level.

Plan Actuary Issues Separate Actuarial Valuation Reports for Each Employer

A-14 As explained previously, employers that participate in an agent plan have to recognize their specific pension amounts. For employers to calculate these amounts, a separate actuarial valuation is needed for each employer based on their specific census data and plan provisions. In order for the employer and the employer auditor to consider the actuary as a management's specialist for the indicated pension amounts, employer management needs to obtain an actuarial valuation report specific to their entity. This guide recommends that the plan's actuary issue and address a separate actuarial valuation report for each employer in the plan, which would include total pension liability, fiduciary net position, net pension liability, deferred outflows of resources and deferred inflows of resources by category and year, pension expense, the discount rate calculation (including comparing projections of the pension plan's fiduciary net position to projected benefit payments), and other standard actuarial information. This guide also recommends the actuarial certification be addressed to employer management.

A-15 In using the work of a management's specialist as evidence, the employer auditor should determine whether the actuarial valuation is relevant and reliable for the employer's financial reporting purposes. In the case of agent plans, the actuary is usually engaged by the plan to perform an actuarial valuation for all participating employers. It is important to understand whether the actuary's work is designed appropriately at the level of each individual employer, as opposed to the plan as a whole. For example, the actuary should consider the appropriateness of assumptions and methods used for each individual employer under GASB Statement No. 68.

Plan Auditor Engaged to Issue Type 2 SOC 1 Report or Issue Examination Report on Controls Over Census Data Maintained by the Plan

A-16 As previously discussed, plans typically maintain the underlying records of plan participants that are no longer employed by the government (that is, inactive or retired members). The plan acts as the record keeper for census data and prepares and maintains the census data file provided to the actuary. Therefore, the employer auditor needs evidence from the plan that census data has been properly accumulated and adjusted over the past year and that appropriate procedures have been performed to determine payments are only made to retired members. This guide recommends two options for how such evidence might be obtained from the plan.

Option 1: Plan Engages Its Auditor to Issue a Type 2 SOC 1 Report on Controls Over Census Data Maintained by the Plan

A-17 Due to the responsibilities of the plan for the census data described previously, the plan is acting as a service organization with regard to the census data maintained by the plan. A *service organization* is defined in AU-C section 402, *Audit Considerations Relating to an Entity Using a Service Organization* (AICPA, *Professional Standards*), as "an organization or segment of an organization that provides services to user entities that are relevant to those user entities' internal control over financial reporting." Option 1 recommends the plan engage its auditor to conduct an attestation engagement under AT-C section 320, *Reporting on an Examination of Controls at a Service Organization Relevant to User Entities' Internal Control Over Financial Reporting* (AICPA, *Professional Standards*), and issue a type 2 SOC 1 report on the controls over census data maintained by the plan. There are two types of SOC 1 engagements. A type 1 engagement tests, among other things, assertions that controls are suitably designed. A type 2 engagement incorporates all the elements of a type 1 engagement but also determines whether such controls were operating effectively during a specified period (that is, the calendar or fiscal year for which the actuarial valuation was performed).

A-18 A type 2 SOC 1 report provides a streamlined way to obtain detailed information on the controls of the plan over a stated period of time. A type 2 SOC 1 report provides

a. descriptions of the controls in place;

b. an independent opinion about whether the controls were suitably designed and operating effectively;

c. a simplified way for the plan to fulfill fiduciary responsibilities; and

d. focus on exceptions and issues.

A-19 Employer auditors should consider the guidance in AU-C section 402. In order to properly utilize a type 2 SOC 1 report, employers and their auditors need to evaluate a number of factors, including the following:

a. The service auditor's professional competence and independence from the service organization

b. Whether the specified period covered by the type 2 SOC 1 report is appropriate for their purposes

c. Nature of the opinion provided in the type 2 SOC 1 report, whether there are any opinion modifications and, if so, how those modifications affect them

d. The sufficiency and appropriateness of the evidence provided by the report for their purposes

e. Whether complementary user entity controls identified by the service organization were appropriately designed and implemented and operating effectively throughout the period covered by the employer's financial statements

A-20 The intent of the type 2 SOC 1 report is to provide evidence that the plan's internal control over the completeness and accuracy of census data maintained by the plan are suitably designed and operating effectively.

Option 2: Plan Engages Its Auditor to Perform Examination Engagement on Census Data Maintained by the Plan

A-21 Under Option 2, the plan would engage its auditor to perform an examination engagement in accordance with AT-C section 205, *Examination Engagements* (AICPA, *Professional Standards*), to provide employers with evidence related to the census data maintained by the plan. The management assertions to which the plan auditor would attest will vary from plan to plan, but the nature of the assertions needs to address the completeness and accuracy of census data for inactive and retired members as well as the accumulation of the census data provided to the actuary.

A-22 The following are illustrations of possible management assertions for use in such an engagement when the plan has a year-end of June 30, 20X3, and uses a beginning of the year actuarial valuation of July 1, 20X2:

a. The census data provided by [*Name of Retirement System*] to the actuary of [*Name of Plan*] as of July 1, 20X2, is complete and accurate based on the accumulation of census data reported by participating employers for the period from July 1, 20X1 to June 30, 20X2. Census data includes the following: [(*list relevant attributes*) for example, date of birth; date of hire; years of service; marital status; pensionable wages; class of employee; gender; date of termination or retirement; spouse's date of birth; employment status; and annual benefit payments for retirees], as set forth in [(*name plan document)*, for example, Chapter X of Example State Compiled Statutes].

b. The census data provided by [*Name of Retirement System*] to the actuary of [*Name of Plan*] as of July 1, 20X2, properly reflects current benefit provisions in effect as of July 1, 20X2, included in [(*name plan document)*, for example, Chapter X of Example State Compiled Statutes].

c. The census data provided by [*Name of Retirement System*] to the actuary of [*Name of Plan*] as of July 1, 20X2, properly excludes deceased members based on the plan's validation of the existence of inactive and retired members by cross-matching Social Security numbers of inactive and retired members with the Social Security Administration as of [*insert date*].

Other Employer and Employer Auditor Responsibilities Relating to Census Data and Specific Pension Amounts

Employer Responsibilities

A-23 The employer is solely responsible for its financial statements and, therefore, employer management is responsible for establishing financial reporting processes and controls over the measurement of its specific pension amounts (for example, total pension liability). Management may have individuals within its organization with appropriate actuarial experience. However, in many cases, management of the employer relies on an external specialist (actuary) who has been engaged by the plan to assist them in preparing an estimate of the specific pension amounts, including total pension liability, through an actuarial valuation. As previously discussed, employer management should receive an actuarial valuation report specific to their entity.

A-24 Numerous assumptions (or inputs) to the actuarial valuation exist that are characterized by predictions of future conditions or events, including (but not limited to) discount rate, salary changes, ad hoc postemployment benefit changes, inflation, and mortality. Many of these assumptions are supported by census data.

A-25 Employer management must support the assumptions with appropriate, reliable, and verifiable information. It ordinarily is not sufficient to rely solely on assumptions provided by the actuary. In some cases, the assumptions may be reliably based on external sources (for example, published interest rates or group experience studies) or internal sources (for example, historical information based on mortality experience studies by the employer). Alternatively, some of the assumptions may be more subjective than others. The extent of subjectivity, such as whether an assumption or input is observable, influences the degree of estimation uncertainty, and thereby, the risk of misstatement.

A-26 In the case of the discount rate, employer management should be able to support the discount rate specific to the employer (not the plan as a whole) based on a projection of the employer-specific fiduciary net position and the amount of projected benefit payments expected to be paid from available employer-specific fiduciary net position in future periods. The long-term expected rate of return component is forward-looking and is usually based on future expected returns that are weighted based on the plan's target asset allocation. The long-term expected rate of return is often supported through modeling and the use of published forward rates, which are evaluated based on the probability of achievement of those rates. It ordinarily is not sufficient to rely solely on past investment experience.

A-27 Employer management must also be able to support the underlying census data used by the actuary. Because the employer has access to the records substantiating the census data provided on active members, the employer should have processes and controls in place to determine that complete and accurate information is reported to the plan and the plan actuary regarding active members. Employer management should obtain on an annual basis the census data file submitted by the plan to the actuary and determine whether the census data is complete and accurate. In evaluating the census data file, the employer may compare the information to underlying payroll records and the prior year census data file. The employer may also obtain a roll forward of the census data from the prior valuation to the current valuation and review a reconciliation for any significant differences.

Employer Auditor Responsibilities

Separate Actuarial Report for Each Employer

A-28 To use the work of the actuary discussed previously (that is, management's specialist) as audit evidence, the employer auditor should evaluate the competence, capabilities, and objectivity of the actuary, obtain an understanding of the work of the actuary, and evaluate the appropriateness of the actuary's work as audit evidence as discussed in paragraph .08 of AU-C section 500. There will ordinarily be an engagement letter or other written form of agreement between the plan and the actuary. Evaluating that agreement when obtaining an understanding of the work of management's specialist may assist the employer auditor in determining

a. the nature, scope, and objectives of the actuary's work;

b. the respective roles and responsibilities of management and the actuary; and

c. the nature, timing, and extent of communication between management and the actuary, including the form of any report to be provided by the actuary.

A-29 Often, an employer auditor may require special skill or knowledge when using an actuarial valuation as audit evidence. This may require the employer auditor to use the work of an auditor's specialist (internal or external) to obtain sufficient appropriate audit evidence. The nature, timing, and extent of the auditor's procedures with respect to the requirements in AU-C section 620, *Using the Work of an Auditor's Specialist* (AICPA, *Professional Standards*), will vary depending on the circumstances, and the auditor should consider the matters in paragraph .08 of AU-C section 620.

A-30 Ultimately, the employer auditor should evaluate whether the actuarial valuation is appropriate and consistent with the requirements of GASB Statement No. 68, the assumptions used by employer management are reasonable in light of the measurement objectives, and the underlying census data is complete and accurate.

A-31 Examples of assertions, identified risks of what can go wrong and audit procedures related to total pension liability, deferred outflows of resources, deferred inflows of resources, and pension expense for employers are discussed in part II of this chapter, which include using the work of the actuary as evidence.

Completeness and Accuracy of Census Data

A-32 When evaluating whether the underlying census data is complete and accurate, the employer and the employer auditor may consider performing procedures over active, inactive, and retired members. Before using the work of the plan auditor as evidence regardless of whether the type 2 SOC 1 examination-level reporting options described previously are used, the employer auditor should evaluate whether the plan auditor's report is adequate and appropriate for the employer auditor's purpose. Part II provides suggested audit procedures for the employer engagement related both to census data and using the work of the plan auditor.

Best Practice Solution for Fiduciary Net Position

Exhibit A-3: Part 2 of Solution

A-33 To obtain sufficient appropriate evidence on the fiduciary net position component of net pension liability (as illustrated in preceding exhibit A-3), this guide recommends the following two-part solution, which is further explained in the following text:

- The plan prepares a schedule of changes in fiduciary net position by employer and related notes to the schedule.

- The plan engages its auditor to opine on the schedule of fiduciary net position by employer through either
  - option 1: an opinion on the schedule as a whole combined with a type 2 SOC 1 report on the controls over the calculation and allocation of additions and deductions to employer accounts or
  - option 2: an opinion on each employer column in the schedule.

A-34 The employer auditor is solely responsible for the audit of the employer's financial statements and, therefore, is responsible for determining the sufficiency and appropriateness of audit evidence necessary to reduce audit risk to an appropriately low level. The solution discussed herein may need to be tailored to fit the particular risks identified at the employer level.

Plan Prepares a Schedule of Changes in Fiduciary Net Position by Employer

A-35 This guide recommends that the plan prepare a schedule of changes in fiduciary net position by employer and related notes to the schedule. Such a schedule could be presented as a stand-alone schedule or included as a supplemental schedule in the plan's financial statements. This schedule would display the additions to fiduciary net position (that is, contributions by employers and plan members and net investment income), deductions from fiduciary net position (that is, pension benefits, including refunds, and administrative expenses), as well as the beginning- and end-of-year net position for each employer. This schedule would provide a starting point for verifying the fiduciary net position component of the net pension liability. An example of this schedule is included in exhibit A-4 that follows.

Exhibit A-4: Example Schedule of Changes in Fiduciary Net Position by Employer

Example Agent Multiple-Employer Pension Plan
Schedule of Changes in Fiduciary Net Position by Employer
As of and for the year ended June 30, 20X5

	Employer 1	*Employer 2*	*Employer 3*	*Total*
Additions:				
Contributions:				
Employer	86,252,000	34,500,000	51,751,000	172,503,000
Plan Member	32,662,000	13,065,000	19,597,000	65,324,000
Net investment income:	80,965,00	20,347,000	37,112,000	138,424,000
Total additions	199,879,000	67,912,000	108,460,000	376,251,000
Deductions:				
Pension benefits, including refunds	384,635,000	184,352,000	228,356,000	797,343,000
Administrative expenses	4,716,000	1,886,000	2,829,000	9,431,000
Total deductions	389,351,000	186,238,000	231,185,000	806,774,000
Net increase (decrease)	(189,472,000)	(118,326,000)	(122,725,000)	(430,523,000)
Net position restricted for pension benefits:				
Beginning of year	5,843,645,000	1,468,538,000	2,678,595,000	9,990,778,000
End of year	$ 5,654,173,000	1,350,212,000	2,555,870,000	9,560,255,000

Plan Engages Its Auditor to Opine on the Schedule of Changes in Fiduciary Net Position by Employer

A-36 The employer auditor needs audit evidence that fiduciary net position and changes in fiduciary net position specific to the employer and included in the employer's financial statements are not materially misstated. This guide recommends two options for the plan auditor reporting on the schedule that could provide such audit evidence for the employer auditor.

Option 1: Plan Engages Its Auditor to Opine on the Schedule as a Whole and to Issue a Type 2 SOC 1 Report on the Controls Over the Calculation and Allocation of Additions and Deductions to Employer Accounts

A-37 Option 1 is based primarily on the plan engaging its auditor to obtain reasonable assurance and report on the schedule of changes in fiduciary net position by employer as a whole and related notes to the schedule in accordance with AU-C section 805, *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement* (AICPA, *Professional Standards*). Because the employer needs evidence related to fiduciary net position as of the end of the period, as well as changes in fiduciary net position during the period, this guide recommends that in reporting on the schedule as a whole, the plan auditor reports on two elements: the fiduciary net position as of the end of the period and the changes in fiduciary net position during the period. Such an approach would involve a separate materiality calculation for each element being opined on (that is, fiduciary net position as of the end of the period and the changes in fiduciary net position during the period).

Emphasis Point

In accordance with paragraphs .08–.09 of Interpretation No. 2, "Auditor of Governmental Agent Multiple-Employer Pension Plan," of AU-C section 805 (AICPA, *Professional Standards*, AU-C sec. 9805 par. .08–.12), when management of an agent plan has calculated and prepared a schedule of changes in fiduciary net position by employer, whether Option 1 or Option 2, and engaged the plan auditor to perform an audit on such a schedule, the schedule may be audited under AU-C section 805.

An illustrative auditor's report on the schedule of changes in fiduciary net position by employer as a whole prepared pursuant to AU-C section 805 is included in example A-1.

A-38 When establishing materiality for the schedule for purposes of reporting on the schedule as a whole, the plan auditor may consider the common needs of the user groups (for example, employers) and the elements on which the auditor is reporting. Accordingly, materiality for the elements of the schedule being opined upon would likely be established at a level lower than for the financial statements of the plan as a whole but higher than the materiality if opining on each employer column. Additionally, when performing the audit of the schedule as a whole, the auditor would ordinarily design the audit so that procedures performed would provide some substantive evidence that amounts are properly reported in the appropriate employer columns. For example, when testing employer contributions, the auditor would likely select a sample that includes multiple employers to obtain evidence about whether the contributions were recorded in the appropriate employer columns. Similarly, when testing pooled investments, the auditor would likely perform substantive procedures to obtain evidence about whether the allocation of investment income to the respective employer accounts is correct.

Emphasis Point

Paragraphs .10–.11 of Interpretation No. 2 of AU-C section 805 address materiality.

AU-C Section 9805, *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement: Auditing Interpretations of Section 805*

.10 *Question*—In planning and performing an audit of the schedule illustrated in exhibit 3 of this interpretation [exhibit A-4 in this chapter], may the plan auditor use the same materiality as used for the audit of the plan's basic financial statements?

.11 *Interpretation*—No. Section 805 states, in part:

> In the case of an audit of one or more specific elements of a financial statement, the auditor should determine materiality for each individual element reported on rather than the aggregate of all elements or the complete set of financial statements.
>
> As a frame of reference, the plan auditor considers judgments about matters that are material to users of the financial statements based on a consideration of the common financial information needs of users as a group. In the report described in paragraph .09 of this interpretation, the auditor is opining on two elements: fiduciary net position and the changes in fiduciary net position. Accordingly, the plan auditor should determine materiality separately for the two elements (that is, fiduciary net position and the changes in fiduciary net position). If the plan auditor has been engaged to opine on each employer column in the schedule, the auditor should determine materiality separately for each employer column.

A-39 In addition to engaging the auditor to report on the schedule as a whole, this guide recommends the plan engage its auditor to provide an in-relation-to opinion as discussed in AU-C section 725, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*), on each employer column in relation to the basic financial statements of the plan as a whole. The in-relation-to opinion is intended to make clear that the auditor is not opining on each employer column. Accordingly, this guide also recommends the auditor clearly state that they are not expressing an opinion on the fiduciary net position or changes in fiduciary net position of each individual employer.

A-40 Although having the auditor opine on the schedule as a whole does provide some evidence that amounts are accurate and reliable for each employer, such an opinion would not provide assurance at a level needed for each individual employer and would not provide sufficient evidence on the allocation of additions and deductions to each employer.

A-41 Although option 1 involves an opinion on the schedule as a whole, individual employers need evidence that their specific interest in the agent plan's fiduciary net position (employer column) is accurate and reliable.

A-42 In order to properly account for each employer's specific interest in the agent plan's fiduciary net position, the plan has to calculate and allocate additions and deductions for each employer's separate account. In this regard, the plan is acting as a service organization. Thus, in option 1, this guide recommends a type 2 SOC 1 report on the controls over the calculation and allocation of additions and deductions to employer accounts because that would give employers evidence that controls over the plan's calculation and allocation of the various additions (that is, contributions and net investment income) and deductions (that is, benefit payments, refunds, and administrative expenses) to employer accounts are suitably designed and operating effectively.

Option 2: Plan Auditor Engaged to Opine on Each Employer Column

A-43 Option 2 is based on the plan engaging its auditor to obtain reasonable assurance and report in accordance with AU-C section 805 on both the schedule as a whole and on each employer column in the schedule of changes in fiduciary net position by employer and related notes to the schedule. Such an approach would involve separate materiality calculations for each employer column in the schedule, as well as the schedule as a whole.

Other Employer and Employer Auditor Responsibilities Relating to Fiduciary Net Position

Employer Responsibilities

A-44 The employer is solely responsible for its financial statements and, therefore, is responsible for establishing financial reporting processes for measuring its net pension liability. The employer has a responsibility to determine whether its specific amounts are accurate and fairly presented (for example, contributions).

Employer Auditor Responsibilities

A-45 The employer auditor is solely responsible for the audit of the employer's financial statements and, therefore, is responsible for determining the sufficiency and appropriateness of audit evidence necessary to reduce audit risk to an appropriately low level. Accordingly, the employer auditor has responsibilities with regard to evaluating whether the employer-specific amounts in the schedule of changes in fiduciary net position by employer are accurate and reliable. Part II of this chapter discusses example assertions, identified risks of what can go wrong, and substantive audit procedures relevant to the employer auditor.

Emphasis Point

Before using the work of the plan auditor as evidence, regardless of whether the plan auditor opined on the schedule as a whole with a type 2 SOC 1 report or on each employer column, the employer auditor should evaluate whether the plan auditor's report and accompanying schedule are adequate and appropriate for the employer auditor's purposes. For example, the employer auditor may review the plan auditor's report and any related opinion modifications and assess other matters discussed in the report. If a SOC report is issued, employer auditors should apply the guidance in AU-C section 402 to properly utilize the report as discussed in the section, "Option 1: Plan Engages Its Auditor to Issue a SOC 1 Type 2 Report on Controls Over Census Data Maintained by the Plan." As required by paragraph .13*a* of AU-C section 402, the employer auditor should be satisfied that the auditor providing the type 2 SOC 1 report is independent and evaluate whether that auditor has the necessary competence for the employer auditor's purposes.

Ramifications If Solutions Not Adopted

A-46 If an agent plan issues audited financial statements but does not implement the solutions recommended by this guide, it is unlikely that employer auditors will be able to accumulate sufficient appropriate audit evidence necessary to provide unmodified opinions on the opinion units of the government financial reporting entity that have material pension amounts. It is important to emphasize that unaudited information provided by the plan to its employers to support specific pension amounts that have not been subjected to further audit procedures would not constitute sufficient appropriate audit evidence upon which employer auditors could base their opinions as discussed in Interpretation No. 3 of AU-C section 500. Although the solutions proposed are recommendations, there are few other alternatives employers and their auditors could efficiently and effectively utilize to obtain sufficient appropriate evidence on which to base their specific pension amounts or the auditor's opinions, respectively.

Example A-1: Illustrative Auditor's Report on the Schedule of Changes in Fiduciary Net Position by Employer as a Whole Prepared Pursuant to AU-C Section 805

Independent Auditor's Report

[*Appropriate Addressee*]

Report on the Schedule

We have audited the fiduciary net position as of June 30, 20X5, and the changes in fiduciary net position for the year then ended, included in the accompanying Schedule of Changes in Fiduciary Net Position by Employer (Schedule) of [*Name of Plan*], and the related notes.[3]

Management's Responsibility for the Schedule

Management is responsible for the preparation and fair presentation of the Schedule in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the Schedule that is free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on the fiduciary net position and the changes in fiduciary net position included in the Schedule based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the fiduciary net position and the changes in fiduciary net position included in the Schedule are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the Schedule. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the fiduciary net position and the changes in fiduciary net position included in the Schedule, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the fiduciary net position and the changes

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[3] If the plan engages its auditor to opine on each employer column in the schedule of changes in fiduciary net position by employer as illustrated in exhibit 3, "Schedule of Changes in Fiduciary Net Position by Employer," of AU-C section 9805, *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement: Auditing Interpretations of Section 805* (AICPA, *Professional Standards*), in addition to opining on the schedule as a whole, this paragraph would be changed as follows:

> We have audited the fiduciary net position as of June 30, 20X5, and the changes in fiduciary net position for the year then ended, included in the accompanying Schedule of Changes in Fiduciary Net Position by Employer (Schedule) of [*Name of Plan*], and the related notes. We have also audited the fiduciary net position of each individual employer as of June 30, 20X5, and the changes in fiduciary net position of each individual employer for the year then ended, included in the accompanying Schedule.

in fiduciary net position included in the Schedule in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the fiduciary net position and the changes in fiduciary net position included in the Schedule.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion [4]

In our opinion, the Schedule referred to above presents fairly, in all material respects, the fiduciary net position of [*Name of Plan*] as of June 30, 20X5, and the changes in fiduciary net position for the year then ended, in accordance with accounting principles generally accepted in the United States of America.

Other Matters [5]

We have audited, in accordance with auditing standards generally accepted in the United States of America, the financial statements of [*Name of Plan*] as of and for the year ended June 30, 20X5, and our report thereon, dated October 15, 20X5, expressed an unmodified opinion on those financial statements.

Our audit of the financial statements of [*Name of Plan*] was conducted for the purpose of forming an opinion on the financial statements as a whole. The individual employer information presented in each of the individual columns of the accompanying Schedule is presented for purposes of additional analysis and is not a required part of the financial statements. The individual employer information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. Each column of individual employer information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the individual employer information presented in each individual column of the accompanying Schedule is stated fairly, in all

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[4] If the plan engages its auditor to opine on each employer column in the schedule of changes in fiduciary net position by employer as illustrated in exhibit A-4, in addition to opining on the schedule as a whole, this paragraph would be changed as follows:

> In our opinion, the Schedule referred to above presents fairly, in all material respects, the fiduciary net position of [*Name of Plan*] as of June 30, 20X5, and the changes in fiduciary net position for the year then ended, in accordance with accounting principles generally accepted in the United States of America. Also, in our opinion, the Schedule referred to above presents fairly, in all material respects, the fiduciary net position of each individual employer as of June 30, 20X5, and the changes in fiduciary net position of each individual employer for the year then ended, in accordance with accounting principles generally accepted in the United States of America.

Additionally, the second paragraph of the "Other Matters" section would be eliminated, and the heading would be singular (that is, "Other Matter").

[5] If the plan is reported as a pension trust fund in the financial statements of another entity, the references in the "Other Matters" section would be to [*Name of Entity*] rather than [*Name of Plan*]. In addition, the auditor may consider adding the following sentence to the end of the first paragraph:

> The [*Name of Plan*] is reported as a pension trust fund in the financial statements of [*Name of Entity*].

material respects, in relation to the financial statements of [*Name of Plan*] as a whole. We do not express an opinion on the fiduciary net position or changes in fiduciary net position of each individual employer.[6]

Restriction on Use

Our report is intended solely for the information and use of [*Name of Plan*] management, [*identify the body or individuals charged with governance of ABC Pension Plan*], [*Name of Plan*] participating employers and their auditors and is not intended to be and should not be used by anyone other than these specified parties.

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

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[6] In accordance with AU-C section 725, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*), if the auditor's report on the audited financial statements contains an opinion other than unmodified, the auditor should refer to the guidance in AU-C section 725.

13.182

Appendix B—Governmental Employer Participation in Cost-Sharing Multiple-Employer Plans: Issues Related to Information for Employer Reporting

> Auditing guidance contained in guide appendixes is considered an *other auditing publication*. Other auditing publications have no authoritative status; however, they may help the auditor understand and apply generally accepted auditing standards.
>
> Although the auditor determines the relevance of these publications in accordance with AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*), the auditor may presume that other auditing publications published by the AICPA that have been reviewed by the AICPA Audit and Attest Standards staff are appropriate.

Cost-Sharing Employers' Recognition of Proportionate Share of Collective Pension Amounts [1]

B-01 A *cost-sharing multiple-employer (cost-sharing) plan* is one in which the participating employers pool their assets and obligations to provide defined pension benefits. That is, plan assets can be used to pay retirees of any participating employer in the plan. Such plans frequently have a large number of participating employers, often in the thousands.

B-02 As discussed in part III, in accordance with GASB Statement No. 68, *Accounting and Financial Reporting for Pensions—an amendment of GASB Statement No. 27*, employers are required to recognize a liability as employees earn their pension benefits (that is, as they provide services to the government). Employers participating in cost-sharing plans report their proportionate share of the collective pension amounts for all benefits provided through the plan. Pension amounts to be recognized by employers include the net pension liability,[2] deferred outflows of resources, deferred inflows of resources, and pension expense. To the extent that a long-term obligation to provide pension benefits (that is, total pension liability) is larger than the value of the assets available in the plan to pay pension benefits, there is a collective net pension liability for which each employer needs to report its proportionate share in their financial statements.

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[1] Some cost-sharing plans include *special funding situations*, which are situations when a nonemployer entity is legally responsible for making contributions directly to a pension plan that is used to provide pensions to the employees of another entity or entities (for example, state government contributes to a local government plan). This guide does not address special funding situations. If such a situation exists, the accounting treatment for the employer would be different than that described in this guide. See GASB Statement No. 68, *Accounting and Financial Reporting for Pensions—an amendment of GASB Statement No. 27*, for more information.

[2] In this guide, references to a net pension liability also apply to situations in which the fiduciary net position exceeds the total pension liability, resulting in a net pension asset.

Employer Issues—Recognizing Proportionate Share of Collective Pension Amounts and Related Auditor Issues

B-03 Each employer participating in a cost-sharing plan needs to obtain all necessary information to support its proportionate share of the collective net pension liability, deferred outflows of resources, deferred inflows of resources, and pension expense. In order to calculate each employer's proportionate share of these collective pension amounts, individual proportions need to be determined by measuring each employer against the total of all the employers participating in the plan.

B-04 Similarly, employer auditors need to obtain sufficient appropriate evidence in order to opine on the pension amounts included in employer financial statements. AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*), states that the objective of the auditor is to design and perform audit procedures that enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.

B-05 The following sections further describe additional considerations related to employer accounting and financial reporting related to participation in cost-sharing plans.

Limitations With the Audited Statements of the Plan

B-06 In accordance with GASB Statement No. 67, *Financial Reporting for Pension Plans—an amendment of GASB Statement No. 25*, the financial statements of cost-sharing plans include only the net pension liability for the plan as a whole but do not include deferred outflows of resources or deferred inflows of resources by category or pension expense for all participating employers. Additionally, the plan financial statements do not include each participating employer's share of the collective pension amounts. As noted in Interpretation No. 2, "Auditor of Participating Employer in a Governmental Cost-Sharing Multiple-Employer Pension Plan," of AU-C section 500 (AICPA, *Professional Standards*, AU-C sec. 9500 par. .23–.29), participating employers and their auditors need information beyond what is provided in the audited financial statements of the plan to determine their proportionate share of the collective pension amounts.

Methods of Allocation

B-07 The basis of an employer's allocation of the collective pension amounts should be consistent with the manner in which contributions to the plan are determined. Although GASB Statement No. 68 encourages an allocation method, often prepared by an actuary, based on an employer's projected long-term contribution effort to the plan as compared to the total projected long-term contribution efforts of all employers contributing to the plan (that is, the actuarial method), the standard allows for other allocation methods to be used, including allocations based on historical measures, such as actual contributions or pensionable wages. Allocations based on historical measures are likely to be more easily substantiated than the actuarial method. However, the use of such a historical measure may not be appropriate in certain circumstances.

Responsible Parties—Allocation Percentages

B-08 An allocation percentage is necessary to derive an employer's proportionate share of the collective pension amounts. GASB Statement No. 68 does not specify which party (that is, plans or employers) is responsible for calculating the allocation percentages. However, cost-sharing plans are in the best position to perform this calculation because they have all necessary information to do so, including the data supporting the allocation measure for each individual employer (that is, the numerator of the calculation) and for all employers (that is, the denominator of the calculation).

B-09 Employers wishing to calculate their own allocation percentages face two issues. First, if individual employers calculate their own allocation, different employers participating in the same plan might allocate collective pension amounts using different bases. Second, employers may not have the necessary data to accurately calculate the allocation. Participating employers would be able to support their individual amount (that is, the numerator of the calculation), but would not likely have access to all employers' corresponding amounts (that is, the denominator of the calculation).

Responsible Parties—Collective Pension Amounts

B-10 As previously discussed, the audited financial statements of cost-sharing plans include only the net pension liability for the plan as a whole, and do not include deferred outflows of resources or deferred inflows of resources by category, or pension expense in total for all participating employers. Although deferred outflows of resources and deferred inflows of resources by category and pension expense are not disclosed in the plan financial statements, they are expected to be calculated by the plan's actuary and included in the actuarial valuation report. Because these amounts relate to all participating employers, it is extremely unlikely that the employer and its auditors would have access to necessary information for the plan as a whole to calculate and verify the collective pension amounts. Clearly, the cost-sharing plans and their actuaries are in the best position to determine these amounts.

Solution for Allocation of Pension Amounts

B-11 This guide recommends that cost-sharing plans calculate each employer's allocation percentage and collective pension amounts. This approach promotes consistency in the calculation as well as minimizes the overall effort and cost incurred by all parties involved. The following discussion provides details regarding this recommendation.

Schedule of Employer Allocations and Allocation Method to Be Used

B-12 This guide recommends that cost-sharing plans prepare a schedule of employer allocations and related notes to the schedule. This schedule displays the proportionate relationship of each employer to all employers and each employer's allocation percentage. This guide further recommends the plan engage its auditor to obtain reasonable assurance and report on the schedule of employer allocations and related notes to the schedule. Such a schedule may be presented as a stand-alone schedule or included as a supplemental schedule to the plan's financial statements. Regardless, the plan auditor forms an opinion and reports on the schedule in accordance with AU-C section 805, *Special Considerations—Audits of Single Financial Statements and Specific Elements,* *Accounts, or Items of a Financial Statement* (AICPA, *Professional Standards*). Note that this guide is not recommending that the plan auditor provide an in-relation-to opinion as discussed in AU-C section 725, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*). This is because the limited assurance provided by an in-relation-to opinion is not sufficient for employers and their auditors to use for purposes of determining that allocation percentages are accurate and reliable.

B-13 As stated in paragraph 48 of GASB Statement No. 68, as amended, the basis of an employer's allocation of the collective pension amounts should be consistent with the manner in which contributions to the plan are determined (that is, the actuarial method or allocations based on historical measures). An example of a schedule of employer allocations based on actual employer contributions is provided in exhibit B-1.

Exhibit B-1: Illustrative Schedule of Employer Allocations

Example Cost Sharing Pension Plan
Schedule of Employer Allocations
6/30/20X5

Employer	*20X5 Actual Employer Contributions*	*Employer Allocation Percentage*
Employer 1	$2,143,842	36.376%
Employer 2	268,425	4.554
Employer 3	322,142	5.466
Employer 4	483,255	8.199
Employer 5	633,125	10.742
Employer 6	144,288	2.448
Employer 7	95,365	1.618
Employer 8	94,238	1.599
Employer 9	795,365	13.495
Employer 10	267,468	4.538
Employer 11	403,527	6.847
Employer 12	165,886	2.815
Employer 13	68,454	1.161
Employer 14	6,240	0.106
Employer 15	2,144	0.036
Total	$5,893,764	100.000%

B-14 Cost-sharing plans need to consider the level of rounding or precision (that is, the number of decimal places) used in preparing the allocation calculation. The relative size of the various employers participating in the plan is a key consideration in determining how to round the allocation percentages. That is, if a cost-sharing plan includes one or more very small employers and other larger employers, the calculation likely requires more precision (that is, more decimal places). For example, in the preceding illustrative schedule, Employer 15 had actual pension contributions of $2,144 and an employer allocation of .036 percent (that is, .00036), using five decimal places. Rounding to anything less than four decimal places would result in no allocation to Employer 15.

Schedule of Pension Amounts by Employer

B-15 In addition to the recommended schedule of employer allocations, this guide also recommends that cost-sharing plans prepare a schedule of pension amounts by employer and related notes to the schedule. This guide further recommends the plan engage its auditor to obtain reasonable assurance and report on total net pension liability, total deferred outflows of resources, total deferred inflows of resources, and total pension expense for the sum of all participating entities included in this schedule. Such a schedule may be presented as a stand-alone schedule or included as a supplemental schedule to the plan's financial statements. Regardless, the plan auditor forms an opinion on each element described previously and reports on the schedule in accordance with AU-C section 805. Note that this guide is not recommending that the plan auditor provide an in-relation-to opinion as discussed in AU-C section 725. This is because the limited assurance provided by an in-relation-to opinion is not sufficient for employers and their auditors to use for purposes of determining that each element described previously is accurate and reliable. In performing the audit of the schedule, the plan auditor may utilize audit evidence obtained during the audit of the financial statements for the public employee retirement system (PERS) as a whole. However, in determining the appropriateness of utilizing such evidence, the plan auditor may need to consider whether the audit procedures were designed at the individual plan level or for the PERS financial statements as a whole.

Emphasis Point

In accordance with Interpretation No. 1, "Auditor of Governmental Cost-Sharing Multiple-Employer Pension Plan," of AU-C section 805 (AICPA, *Professional Standards*, AU-C sec. 9805 par. .01–.07), when management of a cost-sharing plan has calculated and prepared a schedule of employer allocations and a schedule of pension amounts as illustrated in exhibit B-1 and exhibit B-2 or B-3 and engaged the plan auditor to perform an audit on such schedules, the schedules may be audited under AU-C section 805.

An illustrative auditor's report on the schedule of employer allocations and schedule of pension amounts by employer prepared pursuant to AU-C section 805 is included in example B-1.

Emphasis Point

Paragraphs .03–.04 of Interpretation No. 1 of AU-C section 805 address materiality.

> *Question*—In planning and performing an audit of the schedules illustrated in exhibits 1 and 2(a) or exhibit 2(b) of this interpretation [exhibit B-1 and exhibit B-2 or B-3 in this chapter], may the plan auditor use the same materiality as used for the audit of the plan's basic financial statements?
>
> *Interpretation*—No. Section 805 states, in part:
>
>> In the case of an audit of one or more specific elements of a financial statement, the auditor should determine materiality for each individual element reported on rather than the aggregate of all elements or the complete set of financial statements.
>
> Accordingly, the plan auditor would determine materiality separately for the schedule of employer allocations as well as each of the elements upon which the auditor opines from the schedule of pension amounts (that is, the column totals for net pension liability, total deferred outflows of resources, total deferred inflows of resources, and total pension expense).

B-16 The schedule of pension amounts by employer would include the net pension liability, the various categories of deferred outflows of resources and deferred inflows of resources, and pension expense for all participating employers, including differences between expected and actual economic experience;

differences between projected and actual investment earnings, net;[3] and changes of assumptions. Further, each employer is required to recognize two additional types of deferred outflows of resources and deferred inflows of resources related to (*a*) the net impact from changes in proportion (that is, the allocation percentage) between periods and (*b*) differences between actual contributions made by an employer and their proportionate share of total contributions calculated based on the allocation percentage. The proportionate share of the plan pension expense also needs to be adjusted for the amortization of these two additional types of deferrals. Although these additional deferrals and amortization amounts can be calculated separately by each employer, the plan may choose to prepare a schedule of pension amounts by employer that includes this information. Doing so would minimize the potential for error by employers.

Emphasis Point

If an employer receives contributions to separately finance specific liabilities of the individual employer as discussed in paragraph 13.153, the specific liabilities result in pension expense specific to the individual employer. As with the additional deferrals discussed in B-16, the plan may choose to include the pension expense related to separately financed liabilities in the schedule of pension amounts by employer to minimize the potential for error by employers.

B-17 Accordingly, this guide recommends that the plan prepare a schedule of pension amounts by employer using the allocations discussed previously. An example of a schedule of pension amounts by employer is in exhibit B-2:

[3] In accordance with GASB Statement No. 68, the various categories of deferred outflows of resources and deferred inflows of resources are required to be disclosed by participating employers and cannot be netted, except for investment experience (that is, the differences between projected and actual investment earnings).

Exhibit B-2: Illustrative Schedule of Pension Amounts by Employer

Example Cost SharingPension Plan
Schedule of Pension Amounts by Employer
As of and for the year ended 6/30/20X5

		Deferred Outflows of Resources					*Deferred Inflows of Resources*				*Pension Expense*			
Entity	*Net Pension Liability*	*Differences Between Expected and Actual Experience*	*Net Difference Between Projected and Actual Investment Earnings on Pension Plan Investments*	*Changes of Assumptions*	*Changes in Proportion and Differences Between Employer Contributions and Proportionate Share of Contributions*	*Total Deferred Outflows of Resources*	*Differences Between Expected and Actual Experience*	*Changes of Assumptions*	*Changes in Proportion and Differences Between Employer Contributions and Proportionate Share of Contributions*	*Total Deferred Inflows of Resources*	*Proportionate Share of Plan Pension Expense*	*Pension Expense Related to Specific Liabilities of Individual Employers*[4]	*Net Amortization of Deferred Amounts from Changes in Proportion and Differences Between Employer Contributions and Proportionate Share of Contributions*	*Total Employer Pension Expense*
Employer 1	$ 45,224,620	438,859	1,569,847	1,404,206	695,426	4,108,338	355,917	–	726,425	1,082,342	1,907,283	–	12,375	1,919,658
Employer 2	5,661,780	54,942	196,533	175,796	84,231	511,502	44,558	–	74,326	118,884	238,777	–	(1,793)	236,984
Employer 3	6,795,628	65,945	235,892	211,001	117,354	630,192	53,481	–	98,465	151,946	286,596	–	(8,088)	278,508
Employer 4	10,193,442	98,917	353,838	316,502	161,215	930,472	80,222	–	165,453	245,675	429,894	–	3,021	432,915
Employer 5	13,355,038	129,597	463,584	414,668	199,845	1,207,694	105,103	–	197,645	302,748	563,229	–	(9,900)	553,329
Employer 6	3,043,487	29,534	105,646	94,499	53,453	283,132	23,952	–	48,453	72,405	128,355	–	599	128,954
Employer 7	2,011,585	19,520	69,827	62,459	33,458	185,264	15,831	–	35,345	51,176	84,836	–	625	85,461
Employer 8	1,987,964	19,291	69,007	61,725	35,425	185,448	15,645	–	16,453	32,098	83,839	–	(5,712)	78,127
Employer 9	16,777,717	162,811	582,393	520,941	248,356	1,514,501	132,040	–	284,543	416,583	707,576	–	8,405	715,981
Employer 10	5,641,888	54,749	195,843	175,178	95,465	521,235	44,401	–	44,356	88,757	237,938	–	(1,188)	236,750
Employer 11	8,512,562	82,606	295,490	264,312	136,453	778,861	66,993	–	148,543	215,536	359,005	–	1,254	360,259
Employer 12	3,499,761	33,962	121,485	108,666	52,145	316,258	27,543	–	64,354	91,897	147,597	–	453	148,050
Employer 13	1,443,418	14,007	50,104	44,818	23,156	132,085	11,360	–	33,453	44,813	60,874	–	(205)	60,669
Employer 14	131,785	1,279	4,575	4,092	1,968	11,914	1,037	–	894	1,931	5,558	–	147	5,705
Employer 15	44,757	434	1,554	1,390	1,456	4,834	352	–	698	1,050	1,888	–	7	1,895
Total for all Entities	$ 124,325,432	1,206,453	4,315,618	3,860,253	1,939,406	11,321,730	978,435	–	1,939,406	2,917,841	5,243,245	–	–	5,243,245

[4] Pension expense related to specific liabilities of individual employers is discussed in paragraph 56 of GASB Statement No. 68. If these types of liabilities do not exist in a plan, the column may be eliminated.

Schedule of Collective Pension Amounts—Another Alternative

B-18 This guide recommends the schedule of pension amounts by employer illustrated previously because it provides all the elements each employer needs to prepare its financial statements. However, because some of the deferred outflows of resources and deferred inflows of resources and related amortization can be calculated directly by the employer using the percentages in the preceding illustrative schedule of employer allocations (that is, employer-specific amounts), a simpler schedule could be prepared by the plan as illustrated in exhibit B-3. If the plan chose to prepare this alternative schedule, this guide recommends the plan engage its auditor to obtain reasonable assurance and report on the net pension liability, total deferred outflows of resources excluding employer specific amounts, total deferred inflows of resources excluding employer-specific amounts, and pension expense included in this schedule in accordance with AU-C section 805.

Exhibit B-3: Illustrative Schedule of Collective Pension Amounts

Example Cost Sharing Pension Plan
Schedule of Collective Pension Amounts
As of and for the year ended 6/30/20X5

	Deferred Outflows of Resources				*Deferred Inflows of Resources*			
Net Pension Liability	*Differences Between Expected and Actual Experience*	*Net Difference Between Projected and Actual Investment Earnings on Pension Plan Investments*	*Changes of Assumptions*	*Total Deferred Outflows Excluding Employer Specific Amounts**	*Differences Between Expected and Actual Experience*	*Changes of Assumptions*	*Total Deferred Inflows of Excluding Employer Specific Amounts**	*Plan Pension Expense***
$ 124,325,432	1,206,453	4,315,618	3,860,253	9,382,324	978,435	—	978,435	5,243,245

* Employer specific amounts that are excluded from this schedule are the changes in proportion and differences between employer contributions and proportionate share of contributions as defined in paragraphs 54–55 of GASB Statement No. 68, *Accounting and Financial Reporting for Pensions*.

** If specific liabilities of individual employers as defined in paragraph 56 of GASB Statement No. 68 exist, they are not a collective pension amount. Thus, consider changing the caption to "Pension Expense Excluding That Attributable to Specific Liabilities of Individual Employers."

B-19 Under this alternative, each employer would need to calculate two additional types of deferred outflows of resources and deferred inflows of resources, which are employer-specific amounts. These amounts relate to (*a*) the net impact from changes in proportion (that is, the allocation percentage) between periods and (*b*) differences between actual contributions made by an employer and their proportionate share of total contributions calculated based on the allocation percentage.

Emphasis Point

If an employer receives contributions to separately finance specific liabilities of the individual employer as discussed in paragraph 13.153, the specific liabilities result in pension expense specific to the individual employer. As with the additional deferrals discussed in B-19, the employer would need to calculate this amount and adjust pension expense.

Employer and Employer Auditor Responsibilities

B-20 The employer is solely responsible for its financial statements and, therefore, is responsible for evaluating the information used to recognize and disclose pension amounts in its financial statements. Similarly, the employer auditor is solely responsible for the audit of the employer's financial statements and, therefore, is responsible for determining the sufficiency and appropriateness of audit evidence necessary to reduce audit risk to an appropriately low level. Nevertheless, the employer and employer auditor may use the plan auditor's report on the schedules to provide evidence that the pension amounts allocated to the employer and included in the employer's financial statements are not materially misstated.

B-21 Before using the work of the plan auditor as evidence, the employer auditor should evaluate whether the plan auditor's report and accompanying schedules are adequate and appropriate for the employer auditor's purposes. For example, the employer auditor may review the plan auditor's report and any related opinion modifications and assess other matters discussed in the report. Additionally, the employer auditor should evaluate whether the plan auditor has the necessary competence and independence for the employer auditor's purposes.

B-22 Further, the employer and employer auditor have a responsibility to verify and recalculate amounts specific to the applicable employer, including the employer amount used in the allocation percentage (that is, the numerator of the calculation), recalculate the allocation percentage for the employer, and recalculate the pension amounts allocated to the employer based on the allocation percentage. In addition, the employer has responsibilities related to the census data reported to the plan as well as determining the appropriateness of the work of the actuary. Auditing considerations for cost-sharing employers are discussed in part III.

Ramifications If Solutions Not Adopted

B-23 If a cost-sharing plan issues financial statements but does not prepare the preceding schedules or if it does prepare the preceding schedules but does not engage its auditor to opine on them as recommended by this guide, it is unlikely that employer auditors will be able to accumulate sufficient appropriate audit evidence necessary to provide unmodified opinions on opinion units of the government financial reporting entity that have material allocated pension amounts. It is important to emphasize that unaudited information provided by the plan to its employers to support allocations or pension amounts would not be sufficient appropriate audit evidence for their auditors to base their opinions as discussed in Interpretation No. 2 of AU-C section 500. Some have questioned whether, in absence of these recommendations being implemented, additional work by the employer and employer auditor could be performed to adequately verify unaudited amounts provided by the plan. Thus, such an alternative approach would likely not be practical. Employers and their auditors have no direct access to key data of the other employers participating in the plan that supports the employer's proportion of the collective pension amounts. Thus, although the solutions proposed in this guide are recommendations, there are few, if any, alternatives that employers and their auditors could efficiently and effectively utilize to obtain sufficient appropriate evidence on which to base their pension amounts or the audit opinions, respectively.

Example B-1: Illustrative Auditor's Report on the Schedule of Employer Allocations and Schedule of Pension Amounts by Employer Prepared Pursuant to AU-C Section 805

Independent Auditor's Report

[*Appropriate Addressee*]

Report on the Schedules

We have audited the accompanying schedule of employer allocations of [*Name of Plan*] as of and for the year ended June 30, 20X5, and the related notes. We have also audited the total for all entities of the columns titled net pension liability, total deferred outflows of resources, total deferred inflows of resources, and total pension expense (specified column totals) included in the accompanying schedule of pension amounts by employer of [*Name of Plan*] as of and for the year ended June 30, 20X5, and the related notes.[5,6]

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[5] If the plan prepares a schedule of pension amounts by employer and specific liabilities of individual employers as defined in paragraph 56 of GASB Statement No. 68 exist and are not displayed in the schedule, this paragraph would be changed as follows:

> We have audited the accompanying schedule of employer allocations of [*Name of Plan*] as of and for the year ended June 30, 20X5, and the related notes. We have also audited the total for all entities of the columns titled net pension liability, total deferred outflows of resources, total deferred inflows of resources, and total pension expense excluding specific liabilities of individual employers (specified column totals) included in the accompanying schedule of pension amounts by employer of [*Name of Plan*] as of and for the year ended June 30, 20X5, and the related notes.

[6] If the plan prepares a schedule of collective pension amounts as illustrated in exhibit B-3, "Schedule of Collective Pension Amounts," instead of the schedule of pension amounts by employer as illustrated in exhibit B-2, "Schedule of Pension Amounts by Employer," this paragraph would be changed as follows:

> We have audited the accompanying schedule of employer allocations of [*Name of Plan*] as of and for the year ended June 30, 20X5, and the related notes. We have also audited the columns titled net pension liability, total deferred outflows of resources excluding employer specific amounts, total deferred inflows of resources excluding employer specific amounts, and pension expense (specified column totals) included in the accompanying schedule of collective pension amounts of [*Name of Plan*] as of and for the year ended June 30, 20X5, and the related notes.

Additionally, if specific liabilities of individual employers as defined in paragraph 56 of GASB Statement No. 68 exist but are excluded from the schedule, the previous paragraph would refer to pension expense excluding that attributable to specific liabilities of individual employers rather than pension expense.

Management's Responsibility for the Schedules

Management is responsible for the preparation and fair presentation of these schedules in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the schedules that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express opinions on the schedule of employer allocations and the specified column totals included in the schedule of pension amounts by employer based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the schedule of employer allocations and specified column totals included in the schedule of pension amounts by employer are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the schedule of employer allocations and specified column totals included in the schedule of pension amounts by employer. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the schedule of employer allocations and specified column totals included in the schedule of pension amounts by employer, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the schedule of employer allocations and specified column totals included in the schedule of pension amounts by employer in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the schedule of employer allocations and specified column totals included in the schedule of pension amounts by employer.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

Opinions[7,8]

In our opinion, the schedules referred to above present fairly, in all material respects, the employer allocations and net pension liability, total deferred outflows of resources, total deferred inflows of resources, and total pension expense for the total of all participating entities for [*Name of Plan*] as of and for the year ended June 30, 20X5, in accordance with accounting principles generally accepted in the United States of America.

Other Matter[9]

We have audited, in accordance with auditing standards generally accepted in the United States of America, the financial statements of [*Name of Plan*] as of and for the year ended June 30, 20X5, and our report thereon, dated October 15, 20X5, expressed an unmodified opinion on those financial statements.

Restriction on Use

Our report is intended solely for the information and use of [*Name of Plan*] management, [*identify the body or individuals charged with governance of ABC Plan*], [*Name of Plan*] employers and their auditors and is not intended to be and should not be used by anyone other than these specified parties.

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

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[7] If the plan prepares a schedule of pension amounts by employer and specific liabilities of individual employers as defined in paragraph 56 of GASB Statement No. 68 exist and are not displayed in the schedule, this paragraph would be changed as follows:

> In our opinion, the schedules referred to above present fairly, in all material respects, the employer allocations and net pension liability, total deferred outflows of resources, total deferred inflows of resources, and total pension expense excluding specific liabilities of individual employers for the total of all participating entities for [*Name of Plan*] as of and for the year ended June 30, 20X5, in accordance with accounting principles generally accepted in the United States of America.

[8] If the plan prepares a schedule of collective pension amounts as illustrated exhibit B-3 instead of a schedule of pension amounts by employer as illustrated in exhibit B-2, this paragraph would be changed as follows:

> In our opinion, the schedules referred to above present fairly, in all material respects, the employer allocations and net pension liability, total deferred outflows of resources excluding employer specific amounts, total deferred inflows of resources excluding employer specific amounts, and pension expense for [*Name of Plan*] as of and for the year ended June 30, 20X5, in accordance with accounting principles generally accepted in the United States of America.

Additionally, if specific liabilities of individual employers as defined in paragraph 56 of GASB Statement No. 68 exist but are excluded from the schedule, the paragraph would refer to pension expense excluding that attributable to specific liabilities of individual employers rather than pension expense.

[9] If the plan is reported as a pension trust fund in the financial statements of another entity, the reference in the Other Matters section would be to [*Name of Entity*] rather than [*Name of Plan*]. In addition, the auditor may consider adding the following sentence to the end of the Other Matter paragraph:

> The [*Name of Plan*] is reported as a pension trust fund in the financial statements of [*Name of Entity*].

Chapter 14

Defined Benefit Postemployment Benefits Other Than Pensions (Plan & Employer Considerations)

Introduction

14.01 This chapter addresses accounting, financial reporting, and auditing considerations for governmental defined benefit postemployment benefits other than pensions (OPEB) plans and participating governmental employers in those plans. The chapter includes the following sections:

- Part I—Plan Accounting, Financial Reporting, and Auditing Considerations for Defined Benefit OPEB Plans Administered Through a Qualifying Trust
- Part II—Employer Accounting, Financial Reporting, and Auditing Considerations for Defined Benefit OPEB Plans Administered Through a Qualifying Trust: Single and Agent Employers
- Part III—Employer Accounting, Financial Reporting, and Auditing Considerations for Defined Benefit OPEB Plans Administered Through a Qualifying Trust: Cost-Sharing Employers
- Part IV—Employer Accounting, Financial Reporting, and Auditing Considerations for Defined Benefit OPEB Plans That Are *Not* Administered Through a Qualifying Trust

Emphasis Point

The sections of this chapter address the topics related to accounting, financial reporting, and auditing considerations for governmental defined benefit OPEB plans and participating governmental employers in those plans. Because the OPEB-related elements for employers may be dependent on information maintained by the plan, significant interaction among the plans, participating employers, and related auditors may be necessary to corroborate the OPEB amounts in employer financial statements.

Part I of this chapter addresses specific accounting and auditing considerations for defined benefit OPEB plans that are administered through a trust (or equivalent arrangement) that meets the criteria in paragraph 3 of GASB Statement No. 74, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans* (qualifying trust).If an OPEB plan is not administered through a qualifying trust, there is no OPEB plan reporting (that is, a statement of fiduciary net position, a statement of changes in fiduciary net position, notes to basic financial statements, and required supplementary information for the OPEB plan).

Parts II and III of this chapter address specific accounting and auditing considerations for employers participating in single-employer, agent multiple-employer, and cost-sharing multiple employer defined benefit OPEB plans that are administered through a trust (or equivalent arrangement) that meets the criteria in paragraph 4 of GASB Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*.

Part IV of this chapter addresses specific accounting and auditing considerations for governments whose employees are provided with OPEB through OPEB plans that are *not* administered through a trust (or equivalent arrangement) that meets the criteria in paragraph 4 of GASB Statement No 75.

14.02 GASB Statement No. 74 establishes accounting and financial reporting for state and local government OPEB plans—defined benefit OPEB plans and defined contribution OPEB plans—that are administered through a qualifying trust (or equivalent arrangement) in which

- contributions from employers and nonemployer contributing entities to the OPEB plan and earnings on those contributions are irrevocable.
- OPEB plan assets are dedicated to providing OPEB to plan members in accordance with the benefit terms.
- OPEB plan assets are legally protected from the creditors of employers, nonemployer contributing entities, and the OPEB plan administrator. If the plan is a defined benefit OPEB plan, plan assets also are legally protected from creditors of the plan members.

14.03 GASB Statement No. 75 establishes accounting and financial reporting for OPEB provided to the employees of state and local government employers through OPEB plans that are administered through a trust (or equivalent arrangement) that meets the criteria in paragraph 14.02 (hereafter referred to as OPEB plans administered through a qualifying trust). GASB Statement No. 75 also establishes accounting and financial reporting requirements for employers that provide OPEB through OPEB plans that are not administered through a trust (or equivalent arrangement) that meets the criteria in paragraph 14.02 (hereafter referred to as OPEB plans *not* administered through a qualifying trust).

14.04 Although GASB Statement Nos. 74 and 75 apply to both defined benefit and defined contribution OPEB plans, this chapter focuses on defined benefit OPEB plans. Certain plans may have characteristics of both defined benefit and defined contribution OPEB plans. Paragraph 12 of GASB Statement No. 74 specifies three criteria, all of which must be met, for a plan's classification as a defined contribution OPEB plan. This chapter addresses plans and employers that provide OPEB through OPEB plans that are administered through a qualifying trust, as well as employers that provide OBEP through OPEB plans that are not administered through a qualifying trust.

14.05 Although many of the audit objectives for governmental OPEB plans are similar to those for private-sector health and welfare plans, the Employee Retirement Income Security Act of 1974 (ERISA) does not apply to most governmental entities.[1] Instead, state and local laws and regulations that

[1] Certain governmental plans of Indian tribes and educational institutions that report in accordance with generally accepted accounting principles for state and local governmental entities may be subject to the Employee Retirement Income Security Act of 1974 (ERISA) and Department of Labor audit and reporting requirements. The AICPA Audit and Accounting Guide *Employee Benefit Plans* includes guidance on plans subject to ERISA and Department of Labor audit and reporting requirements.

govern the operations of an OPEB plan may affect allowable investments, investment income allocation, funding requirements, member eligibility and vesting, and payments to plan members and beneficiaries. The regulatory environment for governmental OPEB plans will vary significantly from state to state as regulations often come from multiple sources, including state statutes or local government ordinances.

Nature of Transactions

Types of Defined Benefit OPEB Plans

14.06 *Defined benefit OPEB* is OPEB for which benefits that the plan member will receive at or after separation from employment are defined by the benefit terms. The OPEB may be stated as a specified dollar amount, as an amount that is calculated based on one or more factors such as age and years of service, a type or level of coverage such as prescription drug coverage, or a percentage of health insurance premiums.

14.07 OPEB includes health care benefits such as medical, dental, prescription drugs, and vision paid in the period after employment whether provided separately from or provided through a pension plan. OPEB also includes death benefits, life insurance, disability, and long-term care that are paid in the period after employment when provided separately from a pension plan. OPEB does not include termination benefits, which are typically short-term programs put in place to create a voluntary or involuntary reduction in force, or termination payments for unused sick leave.[2]

14.08 Defined benefit OPEB plans other than insured plans are classified first according to the number of employers whose employees are provided with OPEB through the OPEB plan. For purposes of this classification, a primary government and its component units are considered one employer.[3] Accordingly, plans are classified in one of the following categories.

OPEB Plans Administered Through a Qualifying Trust

- *Single-employer*—OPEB is provided to the employees of only one employer.
- *Cost-sharing multiple-employer (cost-sharing)*—OPEB obligations to the employees of more than one employer are pooled and OPEB plan assets can be used to pay the benefits of the employees of any employer that provides OPEB through the OPEB plan.
- *Agent multiple-employer (agent)*—OPEB plan assets are pooled for investment purposes, but separate accounts are maintained for each individual employer so that each employer's share of the pooled assets is legally available to pay the benefits of only its employees.

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[2] Termination benefits are primarily addressed in GASB Statement No. 47, *Accounting for Termination Benefits*, as amended, and termination payments for sick leave are addressed in GASB Statement No. 16, *Accounting for Compensated Absences*.

[3] GASB *Implementation Guide 2015-1* questions 5.125.1.–.3 address the reporting by primary governments and component units. Although this guidance is specific to pension plans, the concept also applies to other postemployment benefits (OPEB) plans.

OPEB Plans Not Administered Through a Qualifying Trust

- *Single-employer*—OPEB is provided to the employees of only one employer.
- *Multiple-employer*—If an OPEB plan is not administered through a qualifying trust, there is no OPEB plan reporting. Thus, for employers that provide benefits through multiple-employer defined benefit OPEB plans that are not administered through a qualifying trust, each individual employer is considered to be participating in their own OPEB plan, similar to a single employer plan that is not administered through a qualifying trust.

Emphasis Point

If postemployment health care benefits (classified as OPEB) and some other benefit that is not OPEB (for example, active employee health care) are administered through a single trust and the assets may legally be used to pay benefits for both active and inactive employees, the arrangement does not meet the requirements of paragraph 3b of GASB Statement No. 74—that is, the OPEB plan assets are not dedicated solely to providing OPEB to plan members in accordance with the benefit terms. In this circumstance, the plan would not be considered to be administered through a qualifying trust (that is, pay-as-you-go), and any assets accumulated in the trust would be considered to be assets of the applicable employer(s), not the plan.

OPEB Financing (Risk Management) and Administrative Arrangements

14.09 The nature of OPEB arrangements and the related audit approach depends on how the risks associated with the current-period benefit payments are financed (paid). The risk associated with current-period benefit payments may be transferred to a third party (for example, purchase of health insurance), fully retained (that is, self-insured), or a combination thereof (for example, partially self-insured with the purchase of stop-loss insurance).

14.10 *When the risks associated with current-period benefit payments are transferred to a third party*, an insurance company usually pools the experience of the plan or employer with that of other similar entities and assumes the financial risk of adverse experience. In such an arrangement, a plan or employer generally has no obligation for current-period benefit payments covered by the arrangement other than the payment of premiums due to the insurance company unless it is an experienced-rated, minimum premium, or stop-loss insurance arrangement. The audit approach will primarily focus on the insurance premiums paid. *When the risks associated with current-period benefit payments are self-insured*, the plan or employer has retained the risk (that is, assumed the obligation) for those benefit payments. The audit approach will primarily focus on the claims payments, which are usually made by a third-party administrator who collects a fee for the services provided.

Emphasis Point—Managed Care Arrangements

In a traditional indemnity plan, the patient's choice of doctors or medical institutions is not restricted, and the plan merely provides for the payment of benefits but makes no arrangement for providing care itself. Managed care arrangements, which are an alternative to traditional indemnity plans, attempt to manage health care delivery with the goal of controlling costs. They affect the way health care is organized, financed, and delivered. In a managed care arrangement, an organization, such as a health maintenance organization (HMO), a preferred provider organization (PPO), or an insurance company provides all or most of the services covered under the plan in return for a capitation fee (that is, a payment on a per capita basis that is fixed without regard to the actual number or nature of services provided to each participant during a set period of time) or a discounted or negotiated fee-for-service basis for using specific providers.

14.11 The audit approach is also affected by the governance structure of the plan. Single-employer OPEB plans are most commonly administered under the same governance structure as the employer. In these circumstances, the plan is usually administered by the employer (or its employees), thus there may not be a substantive distinction between the entity that administers the plan and the employer. Certain aspects of plan administration may be outsourced by the employer to a third-party administrator, including investing and holding assets, maintaining records, receiving contributions, disbursing benefits, and paying expenses. Additionally, when a plan is administered through a qualifying trust under the same governance structure as the employer, often the trust is used solely to accumulate employer contributions for investment purposes (as discussed in the emphasis point after paragraph 14.26). In these circumstances, assets in the trust are not used to pay benefits. Rather, the employer makes benefit payments to inactive plan members from its own resources without reimbursement. Also, assets (or fiduciary net position) of the trust as a percentage of the total OPEB liability are often relatively low in comparison to defined benefit pension plans.

Number of Defined Benefit OPEB Plans—OPEB Plans Administered Through a Qualifying Trust

14.12 As discussed in paragraphs 19 and 23 of GASB Statement Nos. 74 and 75, respectively, if (on an ongoing basis) all assets accumulated in a defined benefit OPEB plan for the payment of benefits may legally be used to pay benefits (including refunds of employee contributions) to any of the plan members (employees), the total assets should be reported as assets of one defined benefit OPEB plan. This would be the case (that is, there would be only one plan) even if (*a*) administrative policy requires that separate reserves, funds, or accounts for specific groups of plan members (employees), employers, or types of benefits be maintained (for example, a reserve for plan member contributions, a reserve for disability benefits, or separate accounts for the contributions of state government versus local government employers), or (*b*) separate actuarial valuations are performed for different classes of plan members (employees) or different groups of plan members (employees) because different contribution rates may apply for each class or group depending on the applicable benefit structures, benefit formulas, or other factors.

Emphasis Point—401(h) Accounts

Certain retiree health (OPEB) benefits may be provided through a 401(h) account that is established by (funded through) a defined benefit pension plan, pursuant to Section 401(h) of the Internal Revenue Code (IRC). As discussed in the following, funding of the 401(h) account can be provided by either (1) a qualified transfer of excess pension plan assets, or (2) an allocation of employer pension plan contributions. The 401(h) account assets used to fund retiree health (OPEB) benefits and the changes in those assets and related liabilities should be reported in the financial statements of the defined benefit OPEB plan (not in the financial statements of the defined benefit pension plan).

Net transfers of excess plan assets to a 401(h) account should be reported as an addition by the defined benefit OPEB plan and a deduction by the defined benefit pension plan in the respective statements of changes in fiduciary net position (that is, it is not appropriate to reflect the caption "transfers" on the statement of fiduciary net position). Allocated employer contributions from a defined benefit pension plan to a 401(h) account should be reported as employer contributions to the defined benefit OPEB plan, not employer contributions to the defined benefit pension plan, in its statement of changes in fiduciary net position. For example, if the total employer contribution to a defined benefit pension plan was $1,000,000 and the plan provisions provided that 25 percent be allocated to the 401(h) account, then $250,000 would be recorded as employer contributions in the OPEB plan's statement of changes in fiduciary net position. Similarly, $750,000 would be recorded as employer contributions in the defined benefit pensions plan's statement of changes in fiduciary net position.

Transfer of Excess Pension Plan Assets

Any assets transferred to a 401(h) account in a qualified transfer of excess pension plan assets (and any income allocable thereto) must be used only to pay qualified current period retiree health benefits for the taxable year of the transfer (whether directly or through reimbursement). Any assets transferred to a 401(h) account in a qualified transfer of excess pension plan assets (and any income allocable thereto) that are not used in the year must be transferred out of the 401(h) account back to the defined benefit pension plan.

The 401(h) assets may be used only to pay current retiree health benefits, which generally are obligations of a separate OPEB plan or health care benefit arrangement. They may not be used to satisfy pension obligations. Although the assets may be invested together with assets that are available to pay pension benefits, a separate accounting must be maintained for all qualified transfers, contributions, distributions or expenses, and income earned thereon.

Allocation of Employer Pension Plan Contributions

The IRC also allows employers to allocate up to 25 percent of total (employer) contributions to the defined benefit pension plan, subject to certain limitations, to the 401(h) account. If the full amount of these contributions is not used during the year, they may be accumulated for future retiree medical expenses in the 401(h) account. The deductibility of employer contributions to a 401(h) account is subject to separate limitations and, therefore, such contributions have no effect on the amount of deductible contributions an employer can make to fund pension benefits under the plan. The earnings on the 401(h) account are ignored for minimum funding purposes. Additionally, qualified transfers are not treated as prohibited transactions for purposes of Section 4975 of the IRC.

Conditions for Payment of Medical Benefits From 401(h) Account

A pension plan may provide for payment of medical benefits for retired employees, their spouses, and their dependents through a 401(h) account if all of the following conditions are met:

- Benefits are subordinate (as defined in Section 401(h) of the IRC) to the retirement benefits provided by the plan.
- A separate account is established and maintained for such benefits.
- The employer's contributions to the separate account are reasonable and ascertainable.
- It is impossible, at any time prior to the satisfaction of all obligations under the plan to provide such benefits, for any part of the corpus or income of the separate account to be (within the taxable year or thereafter) used for, or diverted to, any purpose other than the providing of such benefits.
- Notwithstanding the provisions of certain IRC sections, upon satisfaction of all obligations under the plan to provide such benefits, any amount remaining in the separate account must, under the terms of the plan, be returned to the employer.

14.13 A separate defined benefit OPEB plan should be reported for a portion of the total assets, even if the assets are pooled with other assets for investment purposes, if that portion of assets meets both of the following criteria:

- The portion of assets is accumulated solely for the payment of benefits to certain classes or groups of plan members or to plan members who are active or inactive employees of certain entities (for example, state government employees).
- The portion of assets may not legally be used to pay benefits to other classes or groups of plan members or other entities' plan members (for example, local government employees).

Relevance of Census Data

14.14 The measurement of certain financial statement elements of defined benefit OPEB plan financial statements (for example, total OPEB liability, contributions, contributions receivable, and benefit payments) are dependent on plan members' demographic data, which is referred to as *census data*. Similarly, certain financial statement elements of employers that participate in defined benefit OPEB plans (that is, net [total] OPEB liability, deferred outflows of resources, deferred inflows of resources, and OPEB expense) are also dependent on members' census data. Thus, the relevance of census data to the measurement of certain financial statement elements depends on the basis upon which those financial statement elements are calculated. The relevance of census data also depends on the type of plan (that is, single-employer, cost-sharing, or agent) as accounting and disclosures requirements are different.

14.15 When the OPEB plan and the employer are under different governance structures (for example, the plan is administered by a public employee retirement system [PERS]), different parties typically maintain the underlying records of the census data. Most commonly, employers maintain the underlying records of active members. The plan typically maintains the underlying records of plan members who are no longer employed by a participating employer (that is, inactive members). A description of the typical process for accumulating census data when different governance structures exist for the plan and employer is included in chapter 13 of this guide, "Defined Benefit Pension Plans (Plan & Employer Considerations)," paragraphs 13.12–13.15.

14.16 In contrast, when a plan is administered under the governance structure of the employer (which is the usually the case for most single-employer OPEB plans), often, the same individuals are responsible for maintaining all of the underlying records of the census data. The process to prepare the census data file in these circumstances is usually less sophisticated and often relies on the employer to perform a query of the human resource (personnel) system for active employees to identify eligible employees and the key census data elements, including date of birth, date of hire, and years of services. The extent of testing of the census data by the auditor depends in part on whether the plan (employer) has effective controls over accumulation and preparation of the census data. In these circumstances, auditors are cautioned that the potential risk related to inaccurate and incomplete census data may be higher.

Emphasis Point

When auditing the financial statements of OPEB plans and participating employers, auditors usually use significant amounts of *personally identifiable information* (PII). PII generally refers to any data or information about an individual that, in isolation or when combined with other data, could reasonably be used to identify or contact that person. PII includes information such as name, phone number, email address, Social Security number, account numbers, claim information, and can also include such items as fingerprints, signatures, and other biometric data. Some PII is considered "sensitive" or otherwise deserving of special consideration, particularly in the context of confidentiality. For example, certain jurisdictions explicitly define the following areas of sensitive information that require special handling: information regarding an individual's medical or health conditions; racial or ethnic origin; trade union membership; or similarly sensitive type of information. A person's first and last name is not always considered "private," but when combined with the user's Social Security number, the combination is considered protected PII under certain US laws and various state laws.

It is recommended that auditors carefully consider (1) the risks associated with the collection, processing, storage, transfer, or disposition of PII and the potential processes and controls to manage those risks through physical, procedural, and technical security measures, and (2) legal, regulatory, ethical, and professional obligations to protect PII.

Part I—Plan Accounting, Financial Reporting, and Auditing Considerations for Defined Benefit OPEB Plans Administered Through a Qualifying Trust

Emphasis Point

Part I of this chapter addresses specific accounting and auditing considerations for OPEB plan financial statements prepared in accordance with GASB Statement No. 74 when the OPEB plan is administered through a qualifying trust. If an OPEB plan is not administered through a qualifying trust there is no OPEB plan reporting (that is, a statement of fiduciary net position, a statement of changes in fiduciary net position, notes to basic financial statements, and required supplementary information for the OPEB plan). Accordingly, part I is not applicable for OPEB plans that are not administered through a qualifying trust.

Accounting and Financial Reporting Considerations

General Recognition Standards

14.17 In accordance with paragraph 20 of GASB Statement No. 74, the financial statements of a defined benefit OPEB plan should include the following:

- A statement of fiduciary net position, which includes information about assets, deferred outflows of resources, liabilities, deferred inflows of resources, and fiduciary net position (as applicable) as of the end of the OPEB plan's reporting period
- A statement of changes in fiduciary net position, which includes information about the additions to, deductions from, and net increase (or decrease) in fiduciary net position for the OPEB plan's reporting period

14.18 In accordance with paragraph 140 of GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, as amended, a PERS that administers more than one defined benefit plan (pension, OPEB, or both) that is administered through a qualifying trust is required to present combining financial statements for all plans administered by the system and, if applicable, required schedules for each plan. A PERS should meet this financial statement requirement by presenting (*a*) a separate column for each plan administered on the statement of fiduciary net position and the statement of changes in fiduciary net position, or (*b*) combining statements for those plans as part of the basic financial statements. Chapter 4, "General Auditing Considerations," of this guide discusses GASB guidance to preparers on materiality determinations.

Emphasis Point

In accordance with paragraphs 58–59 of GASB Statement No.74, if an OPEB plan is not administered through a qualifying trust, any assets accumulated for OPEB purposes should continue to be reported as assets of the employer or nonemployer contributing entity. When a government holds assets in a fiduciary capacity (for example, for other governments that are not included in the reporting entity), those assets should be reported in an agency fund. Balances reported in the agency fund should exclude amounts that pertain to the employer or nonemployer contributing entity that reports the agency fund.

Update 14-1 *Fiduciary Activities*

GASB Statement No. 84, *Fiduciary Activities*, establishes criteria for identifying and reporting fiduciary activities. The criteria for identification of fiduciary activities primarily focuses on (*a*) whether a government controls the assets of the fiduciary activity and (*b*) the beneficiaries with whom a fiduciary relationship exists.

Governments with activities meeting the criteria will present a statement of fiduciary net position and a statement of changes in fiduciary net position, with certain exceptions.

There are four classifications of fiduciary funds described in GASB Statement No. 84: (1) pension (and other employee benefit) trust funds, (2) investment trust funds, (3) private-purpose trust funds, and (4) custodial funds. Custodial funds should report fiduciary activities that are not held in a trust or equivalent arrangement that meets specific criteria. Note that agency funds will no longer be reported upon application of this statement.

The statement was issued in January 2017 and is effective for fiscal years beginning after December 15, 2018. Earlier application is encouraged.

Upon its effective date, GASB Statement No. 84 will affect the guidance in this chapter.

The full text of the statement is available on GASB's website at www.gasb.org.

Statement of Fiduciary Net Position

14.19 In accordance with paragraph 21 of GASB Statement No. 74, OPEB plan assets should be subdivided into (*a*) the major categories of assets held (for example, cash and cash equivalents, receivables, investments, and capital assets) and (*b*) the principal components of the receivables and investments categories.

14.20 *Receivables*. In accordance with paragraph 22 of GASB Statement No. 74, receivables are generally short-term and consist of contributions due at the end of the reporting period. Amounts recognized as receivables for contributions should include only those due pursuant to legal requirements. In accordance with paragraph 23 of GASB Statement No. 74, receivables for contributions that are payable to the OPEB plan more than one year after the end of the reporting period (for example, pursuant to an installment contract) should be recognized in full in the period the receivable arises. Additional receivables could include refunds or rebates from service providers or certain subsidies from governmental agencies.

14.21 *Investments*. In accordance with paragraph 24 of GASB Statement No. 74, purchases and sales of investments should be recorded on a trade date basis. Except as otherwise outlined in paragraph 69 of GASB Statement No. 72, *Fair Value Measurement and Application*, as amended, investments should be reported at fair value. Chapter 5 of this guide, "Investments, Certain Equity Interests, and Derivatives," discusses reporting investments at fair value.

14.22 *Liabilities.* As discussed in paragraph 26 of GASB Statement No. 74, liabilities generally consist of benefits due to plan members and accrued investment and administrative expenses. OPEB plan liabilities for benefits should be recognized when the benefits are currently due and payable in accordance with the benefit terms. OPEB plan liabilities should also include amounts of benefit payments that are owed by employers or nonemployer contributing entities for OPEB as the benefits come due.

14.23 *Fiduciary Net Position.* As discussed in paragraph 27 of GASB Statement No. 74, assets, plus deferred outflows of resources, less liabilities, less deferred inflows of resources at the end of the OPEB plan's reporting period should be reported as net position restricted for OPEB.

Statement of Changes in Fiduciary Net Position

14.24 Paragraph 28 of GASB Statement No. 74 addresses the additions section of the statement of changes in fiduciary net position, which should separately display contributions from employers and those from nonemployer contributing entities, each including amounts for OPEB as the benefits come due that will not be reimbursed to the employers using OPEB assets, the total of contributions from active and inactive plan members not receiving benefits including those transmitted by employers, and net investment income, including separate display of investment income and investment expense.[4]

> ***Emphasis Point***
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> GASB Statement No. 74 defines *nonemployer contributing entities* as entities that make contributions, including amounts for OPEB as the benefits come due, to an OPEB plan that is used to provide OPEB to the employees of other entities. For purposes of the Statement, plan members are not considered nonemployer contributing entities.
>
> Thus, the additions section would include contributions received directly by the plan from any nonemployer contributing entity, whether in a special funding situation or not.

14.25 Investment income includes the following:

a. The net increase (decrease) in the fair value of OPEB plan investments

b. Interest income, dividend income, and other income not included in (*a*)

Components (*a*) and (*b*) of investment income may be separately displayed or combined and reported as one amount.

14.26 Paragraph 13 of GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, as

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[4] As discussed in paragraph 30 of GASB Statement No. 74, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, if investment-related costs can be separated from investment income and administrative expenses of the plan, they should be reported as investment expense.

amended, states that the net increase (decrease) in fair value of investments should include realized gains and losses on investments that were both bought and sold during the period. Realized and unrealized gains and losses should not be separately displayed in the financial statements. Realized gains and losses, computed as the difference between the proceeds of sale and the original cost of the investments sold, may be disclosed in notes to financial statements.

Emphasis Point—OPEB Paid Directly by Employer

Employers often make contributions to a qualifying OPEB trust solely for investment purposes. In these circumstances, assets in the trust are not used to make benefit payments during the period; instead the employer makes benefit payments to inactive (retired) plan members from its own resources without reimbursement. The objective of GASB Statement No. 74 is to report on all activity of the OPEB plan. Accordingly, paragraph 28a of GASB Statement No. 74 requires that additions to plan fiduciary net position include contributions from the employers and specifically indicates that those contributions should include amounts for OPEB as the benefits come due that will not be reimbursed to the employers using OPEB plan assets. Additionally, paragraph 31 of GASB Statement No. 74 requires that deductions from OPEB plan fiduciary net position include benefit payments. In the circumstances described, an amount equal to the benefit payments should be recognized both as an addition (contribution) to and a deduction (benefit payment) from OPEB plan fiduciary net position.

14.27 Paragraph 31 of GASB Statement No. 74 states that the deductions section of the statement of changes in fiduciary net position should, at a minimum, separately display benefit payments (including refunds of plan member contributions and amounts from employers or nonemployer contributing entities for OPEB as the benefits become due) and total administrative expenses. Benefit payments should exclude amounts paid by inactive plan members (that is, gross benefit costs should be reduced by the amount paid by inactive plan members when reporting benefit payments).

Emphasis Point—Implicit Rate Subsidy

Employers often provide (purchase) health care benefits for active employees and inactive employees based on blended premium rates for all covered individuals. In this circumstance, benefit payments reported by the plan are measured as the difference between (*a*) the claims costs, or age-adjusted premiums approximating claims costs, for the inactive employees in the group for the period, and (*b*) the amounts required to be paid by the inactive employees for that period. The amount of the age-adjusted premiums in excess of the blended premium rates for inactive members is often referred to as the implicit rate subsidy. The amount of the implicit rate subsidy for each period is also reported as an employer contribution.

14.28 The difference between total additions and total deductions is reported as the net increase (decrease) in net position.

Note Disclosures and Required Supplementary Information

14.29 Paragraph 34 of GASB Statement No. 74, addresses the note disclosures in the financial statements applicable to all plans, regardless of type. The following are among the categories of required disclosures:

- Plan description
- OPEB plan investments
- Receivables
- Allocated insurance contracts
- Reserves

14.30 It is important to note that the plan should include other applicable disclosures required by other GASB standards as well as required supplementary information (RSI) (for example, management's discussion and analysis).

Additional Considerations for Single-Employer and Cost-Sharing OPEB Plans

14.31 Paragraph 35 of GASB Statement No. 74 addresses additional note disclosure requirements of single-employer and cost-sharing OPEB plans. The following are among the required disclosures, as applicable:

- Components of net OPEB liability, including total OPEB liability, plan's fiduciary net position, net OPEB liability, and OPEB plan's fiduciary net position as a percentage of the total OPEB liability[5]
- Significant assumptions used to measure total OPEB liability, including inflation, healthcare cost trend rates, salary changes (if applicable), ad hoc postemployment benefit changes (including ad hoc cost of living adjustments [COLAs]), sharing of benefit-related costs with inactive plan members, discount rate, and mortality (See paragraph 14.47 of this chapter if the alternative measurement method is used to measure total OPEB liability.)
- Date of actuarial valuation or alternative measurement method calculation on which the total OPEB liability is based

14.32 In addition, single-employer and cost-sharing OPEB plans have to present certain 10-year schedules of RSI[6] as discussed in paragraph 36 of GASB Statement No. 74, including information on the changes in the net OPEB liability, key ratios, information on contributions, and the annual money-weighted rate of return on OPEB plan investments.

Additional Considerations for Agent OPEB Plans

14.33 Agent OPEB plans do not have any specific note disclosure requirements or RSI related to OPEB liabilities or actuarial information.

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[5] In this guide, references to a net OPEB liability also apply to situations in which the fiduciary net position exceeds the total OPEB liability resulting in a net OPEB asset.

[6] Chapters 4, "General Auditing Considerations," and 16, "Audit Reporting," of this guide discuss the auditor's responsibility for required supplementary information, including auditor reporting.

14.34 Paragraph 37 of GASB Statement No. 74 requires agent OPEB plans to disclose as RSI a 10-year schedule of the annual money-weighted rate of return on OPEB plan investments.[7]

Measurement of the Net OPEB Liability for Single-Employer and Cost-Sharing OPEB Plans

14.35 As discussed in paragraph 39 of GASB Statement No. 74, the net OPEB liability equals the total OPEB liability for the OPEB plan, less the fiduciary net position of the plan. Total OPEB liability is the actuarial present value of projected benefit payments attributed to past employee service. Fiduciary net position is determined using the same valuation methods that are used for the plan's financial reporting.

14.36 Determining the total OPEB liability is a three step process: (1) projecting future benefit payments, (2) discounting projected future benefit payments to present value, and (3) attributing present value of projected future benefits to past and future periods.

Timing and Frequency of Actuarial Valuations

14.37 Paragraph 41 of GASB Statement No. 74 indicates that the total OPEB liability should be determined by (*a*) an *actuarial valuation* as of the OPEB plan's most recent fiscal year-end or (*b*) the use of update procedures to roll forward to the OPEB plan's most recent fiscal year-end amounts from an actuarial valuation as of no more than 24 months earlier than the OPEB plan's most recent fiscal year-end.[8] If update procedures are used and significant changes occur between the *actuarial valuation date* and the OPEB plan's fiscal year-end, professional judgment should be used to determine the extent of procedures needed to roll forward the measurement from the actuarial valuation to the OPEB plan's fiscal year-end, and consideration should be given to whether a new actuarial valuation is needed. For purposes of this determination, the effects of changes in the discount rate resulting from changes in the OPEB plan's fiduciary net position or from changes in the municipal bond rate, if applicable, should be among the factors evaluated. For financial reporting purposes, an actuarial valuation of the total OPEB liability should be performed at least biennially. However, GASB encourages more frequent actuarial valuations.

Emphasis Point

It is important for plans to consider the needs of participating employers in determining the timing and frequency of actuarial valuations, especially if the plan chooses to perform actuarial valuations on a biennial basis. GASB Statement No. 74 requires the actuarial valuation to be performed within 24 months of the plan's fiscal year-end. GASB Statement No. 75 requires the total OPEB liability for employers to be determined by an actuarial valuation that is within 30 months and 1 day from the employer's most recent fiscal

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[7] See footnote 4.

[8] In accordance with paragraph 42 of GASB Statement No. 74, unless otherwise specified by GASB Statement No. 74, the selection of all assumptions used in determining the total OPEB liability and related measures should be made in conformity with Actuarial Standards of Practice issued by the Actuarial Standards Board. The OPEB plan, employer, and, if any, governmental nonemployer contributing entities that make contributions to the OPEB plan should use the same assumptions when measuring similar or related OPEB information.

year-end. It is possible for a plan's valuation to be in compliance with the requirements of GASB Statement No. 74 but be outside the time frame set forth for employers.

Projection of Benefit Payments

14.38 In accordance with paragraph 43 of GASB Statement No. 74, projected benefit payments should include all benefits to be provided to current active and inactive members through the OPEB plan (including amounts for OPEB to be paid by employers or nonemployer contributing entities as the benefits become due) in accordance with the benefit terms and any additional legal agreements to provide benefits that are in force at the OPEB plan's fiscal year-end. Usually, a written document is the best evidence of the benefit terms. However, in some cases, the substantive plan may differ from the written document. Accordingly, other information also should be taken into consideration in determining the benefits to be provided, including communications between the employer and plan members (active and inactive) and an established pattern of practice with regard to the sharing of benefit-related costs with inactive members.

14.39 In accordance with paragraphs 44 and 45 of GASB Statement No. 74, projected benefit payments should include the effects of the following:[9]

a. Projected ad hoc postemployment benefit changes, including ad hoc cost-of-living adjustments (ad hoc COLAs), to the extent that they are considered to be substantively automatic[10]

b. Projected salary changes (in circumstances in which the OPEB formula incorporates future compensation levels)

c. Projected service credits (both in determining a member's probable eligibility for benefits and in the projection of benefit payments in circumstances in which the OPEB formula incorporates years of service)

d. Taxes or other assessments expected to be imposed on benefit payments using rates in effect at the OPEB plan's fiscal year-end or, if different rates have been approved by the assessing government to be applied in future periods, the rates approved by the assessing government associated with the periods in which the assessments on the benefit payments will be imposed

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[9] In accordance with paragraph 25 of GASB Statement No. 74, benefit payments to be provided by means of an *allocated insurance contract* should be excluded from projected benefit payments if (*a*) the contract irrevocably transfers to the insurer the responsibility for providing the benefits, (*b*) all required payments to acquire the contract have been made, and (*c*) the likelihood is remote that the employer or the OPEB plan will be required to make additional payments to satisfy the benefit payments covered by the contract.

[10] Considerations that might be relevant in determining whether such changes are substantively automatic include the historical pattern of granting the changes, the consistency in the amounts of the changes or in the amounts of the changes relative to a defined cost-of-living or inflation index, and whether there is evidence to conclude that changes might not continue to be granted in the future despite what might otherwise be a pattern that would indicate such changes are substantively automatic.

Emphasis Point—Impact of Participation Rate on Projection of Benefits

The expected participation rate will often have a significant impact on the projection of benefits. For plans that require some form of contribution to maintain coverage, some eligible individuals may elect not to be covered, particularly if they have other coverage available. In accordance with Actuarial Standard of Practice No. 6, *Measuring Retiree Group Benefit Obligations*, empirical data on plan participation, where available and credible, should be considered when selecting the participation assumption for future retirees. When developing the participation rates, the actuary should consider how plan eligibility rules, plan choices, or retiree contribution rates have changed over time.

Furthermore, plan participation may be different in the future due to participants' response to changes in retiree contribution levels and plan choices (for example, Medicare+Choice). For plans that anticipate changes in retiree contributions, the actuary should consider the appropriateness of participation rates that vary over the projection period for both current and future retirees. The actuary should consider plan eligibility rules governing dropping coverage and subsequent reenrollment when selecting participation rates.

14.40 Projected benefit payments should be based on claims costs, or age-adjusted premiums approximating claims costs, in accordance with Actuarial Standards of Practice issued by the Actuarial Standards Board. For this purpose, a deviation, as the term is used in Actuarial Standards of Practice, from the guidance in an Actuarial Standard of Practice is not considered to be in conformity with the requirement in paragraph 43 of GASB Statement No. 74. Additionally, projected benefit payments should consider a legal or contractual cap on benefit payments for OPEB for each period in projecting benefit payments (if the cap has been enforced in the past), as well as other relevant factors and circumstances.

Discounting Projected Future Benefits

Discount Rate

14.41 For purposes of applying GASB Statement No. 74, the discount rate is the single rate of return that, when applied to all projected benefit payments, results in an actuarial present value of projected benefit payments equal to the total of the actuarial present values determined in conformity with paragraph 48 of GASB Statement No. 74, as follows. A single blended discount rate should be based on both of the following:

a. The long-term expected rate of return on OPEB plan investments that are expected to be used to finance the payment of benefits, to the extent that plan fiduciary net position is projected to be sufficient to make projected benefit payments and plan assets are expected to be invested using a strategy to achieve that return

b. A yield or index rate for 20-year, tax-exempt general obligation municipal bonds with an average rating of AA/Aa or higher (or equivalent quality on another rating scale), to the extent that the conditions in (*a*) are not met

Comparing Projections of the OPEB Plan's Fiduciary Net Position to Projected Benefit Payments

14.42 As discussed in paragraph 49 of GASB Statement No. 74, for purposes of applying the discount rate, the amount of the OPEB plan's projected fiduciary net position and the amount of projected benefit payments should be compared in each period of projected benefit payments. Projections of the OPEB plan's fiduciary net position should incorporate all cash flows for (*a*) contributions from employers and nonemployer contributing entities, if any, intended to finance benefits of current active and inactive members (status at the OPEB plan's fiscal year-end), and (*b*) all cash flows for contributions from current active members.[11]

14.43 Paragraph 50 of GASB Statement No. 74 states that professional judgment should be applied to project cash flows for contributions from employers and nonemployer contributing entities in circumstances in which (*a*) those contribution amounts are established by statute or contract or (*b*) a formal, written policy related to those contributions exists. Application of professional judgment should consider the most recent five-year contribution history of the employers and nonemployer contributing entities as a key indicator of future contributions from those sources and should reflect all other known events and conditions. In circumstances other than those described in (*a*) and (*b*), the amount of projected cash flows for contributions from employers and nonemployer contributing entities should be limited to an average of contributions from those sources over the most recent five-year period and may be modified based on consideration of subsequent events.

Calculating the Discount Rate

14.44 In accordance with paragraph 52 of GASB Statement No. 74, for each future period, if (*a*) the amount of the OPEB plan's fiduciary net position is projected to be greater than or equal to the benefit payments that are projected to be made in that period and (*b*) OPEB plan assets up to that point are expected to be invested using a strategy to achieve the long-term expected rate of return, the actuarial present value of benefit payments projected to be made in the period should be determined using the long-term expected rate of return on those investments.

14.45 In accordance with paragraph 52 of GASB Statement No. 74, the long-term expected rate of return should be based on the nature and mix of current and expected OPEB plan investments over a period representative of the expected length of time between (*a*) the point at which a member begins to provide service to the employer and (*b*) the point at which all benefits to the member have been paid. For this purpose, the long-term expected rate of return should be determined net of OPEB plan investment expense but without reduction for OPEB plan administrative expense. The municipal bond rate previously discussed in paragraph 14.41*b* should be used to calculate the actuarial present value of all other benefit payments.

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[11] Paragraph 51 of GASB Statement No. 74 states, if the evaluations required by paragraph 49 can be made with sufficient reliability without a separate projection of cash flows into and out of the OPEB plan, alternative methods may be applied in making the evaluations.

Attributing the Actuarial Present Value of Projected Benefit Payments to Periods

14.46 Attribution of the present value of projected future benefit payments to specific periods should be based on the entry age actuarial cost method in accordance with the requirements of paragraph 54 of GASB Statement No. 74.

Alternative Measurement Method for Total OPEB Liability (if fewer than 100 participants)

14.47 If an employer has fewer than 100 participants (active and inactive) as of the beginning of the OPEB plan's fiscal year, the total OPEB liability *may* be measured using the alternative measurement method discussed in paragraphs 56–57 of GASB Statement No. 74.

Auditing Considerations for OPEB Plans Administered Through a Qualifying Trust

14.48 This section discusses audit considerations, including describing the relevant assertions when auditing the OPEB plan's basic financial statements (whether as a stand-alone plan or an other employee benefit trust fund included within the primary government's financial statements). This section does not include all risks or all procedures that could apply to such audits in accordance with generally accepted auditing standards; instead, this section focuses on specific considerations for testing certain financial statement elements. The examples of substantive audit procedures are not considered required procedures, nor are they all-inclusive.

Emphasis Point

As discussed in the emphasis point after paragraph 14.01, the OPEB-related elements for employers participating in plans that are administered through a qualifying trust (discussed in parts II and III of this chapter) may be dependent on information maintained by the plan requiring significant interaction between the plans, participating employers, and auditors for purposes of corroborating OPEB amounts in employer financial statements.

The following section discusses specific auditing considerations for plan financial statements prepared in accordance with GASB Statement No. 74. Appendixes A–B of chapter 13 of this guide provide guidance when plan auditors are engaged to provide similar assurance services for defined benefit pension plans and also discuss related materiality considerations, which may be at a lower level than that of the financial statement audit. Therefore, OPEB plan auditors may want to consider the guidance in appendixes A–B of chapter 13, adapted as appropriate for defined benefit OPEB plans, when planning the audit of the OPEB plan financial statements to gain an understanding of the materiality differences in order to effectively coordinate the work performed for both of the engagements.

Although the guidance in these appendixes is integral to the audit of the employer's financial statements, these appendixes are *other auditing publications* and are nonauthoritative.

Determining Audit Strategy

14.49 Determining the strategy for the OPEB plan audit requires the auditor to understand the type of plan (that is, single-employer plan or multiple-employer plan [cost-sharing or agent] as defined in paragraph 14.08), whether there are multiple plans in a system, and what activities the various parties perform. Example activities include investing and holding plan assets, maintaining records, determining OPEB liabilities, receiving contributions, disbursing benefits (premiums and claim payments) and paying expenses. Additionally, understanding the key provisions (for example, eligibility, contributions, and benefit payments of the substantive plan) will assist the auditor in designing an appropriate audit strategy.

Emphasis Point—Determining the Substantive Plan

The term *substantive plan* is used in GASB Statement No. 74 to describe the terms of the OPEB plan as they are understood by the employer and plan members. As noted in paragraph 43 of GASB Statement No. 74, the substantive plan may differ from the benefit terms that are described in a written document (for example, plan document). If a comprehensive plan document exists, that document may provide the best evidence of what the substantive plan is. However, in some cases, there may not be a comprehensive plan document that fully and accurately reflects the understanding of benefit terms by the parties. For example, a plan document may state generally that the employer will provide postemployment health care benefits but not specify the types or levels of benefits, the eligibility requirements, or the periods over which the benefits will be provided—or the employer may have a long-established practice of providing benefits in addition to what is stated in an original plan document. Additionally, unlike pension benefits, employers often participate in annual contract negotiations with their various service providers related to OPEB which often change the benefits and services offered or selected and must be considered when determining the plan provisions that collectively make up the substantive plan as of the measurement date.

When determining what provisions constitute the substantive plan, there are often several documents (that may be independent from one another) that should be considered, including the following:

- Health care plan (Often there will be more than one for the type of plan and the type of benefit.)
- Administrative policies
- Collective bargaining agreements
- Ordinances or state statutes (that allows retirees to stay on the health care plan)
- OPEB trust documents (indicating, for example, how the trust is governed and what investments are allowed)
- Other communications between the employer and plan members

Accordingly, all relevant information (including documents and historical patterns of practice with regard to the sharing of benefit-related costs with inactive members) should be considered when identifying the provisions of the substantive plan and the basis for the projection of benefit payments for financial reporting purposes.

14.50 Once the auditor understands the type of plan and the party responsible for each activity, understanding the risks of what can go wrong to assess material risk of misstatement surrounding those activities is necessary to determine the nature, timing, and extent of testing. (See chapter 4 for a discussion of the auditor's risk assessment and response to assessed audit risk.) Given the interaction between the plan and participating employers, there are often both shared and divided responsibilities for certain elements.

14.51 The auditor should apply the concept of opinion units in planning, performing, evaluating the results of, and reporting on financial statements that include defined benefit OPEB plans. Chapter 4 discusses opinion units required for an audit of a government's basic financial statements, which includes the following points:

a. A general purpose government that includes a defined benefit OPEB plan as part of its financial reporting entity presents the plan as part of the aggregate remaining fund information.

b. A government that engages only in fiduciary activities has only one opinion unit that represents aggregate remaining fund information.

For a PERS with more than one defined benefit plan (pension, OPEB, or both) that presents separate financial statements for each plan (as required by GASB Statement No. 67, *Financial Reporting for Pension Plans—an amendment of GASB Statement 25, as amended,* and GASB Statement No. 74, respectively), those separate plan financial statements do not represent separate opinion units but, rather, are aggregated into a single opinion unit. Auditors should make separate materiality determinations for each opinion unit for purposes of planning, performing, evaluating the results of, and reporting on the audit of government's basic financial statements. An auditor may be engaged to report at a lower level than the opinion unit. For example, if the auditor is engaged to report on each individual plan, the auditor should set the scope and assess materiality to align with the individual plan level of reporting.

14.52 AU-C section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* (AICPA, *Professional Standards*), requires the auditor to consider whether evaluating the entity's compliance with legal and contractual provisions is needed as part of the financial statement audit, particularly when noncompliance with state and local laws and regulations that govern the operations of an OPEB plan may materially affect the financial statements. As discussed in paragraph 14.05, the regulatory environment for plans will vary significantly. Chapter 4 of this guide discusses the auditor's responsibility (under AU-C section 250) to plan and perform the audit to obtain evidence about whether the financial statements are free from material misstatements arising from noncompliance with provisions of laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements. Chapter 4 also describes the auditor's responsibility regarding the provisions of laws and regulations that do not have a direct effect on the determination of material amounts and disclosures in the financial statements but compliance with which may be fundamental to the operating aspects of the business, fundamental to an entity's ability to continue its business, or necessary for the entity to avoid material penalties.

Census Data Considerations for Single-Employer and Cost-Sharing OPEB Plans

14.53 As discussed in paragraph 14.14, the measurement of certain financial statement elements of single-employer and cost-sharing OPEB plans depends on the completeness and accuracy of census data. The auditor's consideration of the relevant financial statement assertions that depend on census data begins with understanding the processes and controls used by management of the plan to support the completeness and accuracy of the significant elements of census data that are ultimately provided to the actuary. This would include the processes and controls over significant elements of census data received from participating employers.

14.54 *Significant elements of census data* include those elements that, either individually or when combined with other elements, could result in a material misstatement to one or more elements of the plan's financial statements (for example, total OPEB liability, contributions, contributions receivable, and benefit payments). Significant elements of census data may include some or all of the following:

a. Name

b. Social Security number

c. Date of birth

d. Date of hire

e. Marital status

f. Dependents

g. Service credits (periods of time worked)

h. Class of employee

i. Position or job code (or both)

j. Gender

k. Date of termination or retirement

l. Spouse's date of birth

m. Employment status (active, inactive entitled to but not receiving benefits, retired)

The significance of some of these elements, all of these elements, or additional elements to any plan will be based on the impact that a particular census data element has on the measurement of a particular financial statement element.

Emphasis Point

Many OPEB plans allow members to choose from more than one health care plan option through an annual open enrollment process (for example, an HMO, PPO, or traditional indemnity plan). Although the benefits election is not an element of census data, such elections are considered in the utilization assumptions by the actuary in projecting benefit (claims) costs in the actuarial valuation.

14.55 The example audit procedures related to testing census data (including underlying data at the participating employer[s], the plan's accumulation of such data, and how the census data is reported to the actuary) are included in the section "Census Data," beginning at paragraph 14.97 of this chapter.

14.56 The substantive procedures over census data are ordinarily based on a concept that focuses on testing incremental changes to the census data file since the prior actuarial valuation, assuming (*a*) the prior year plan financial statements were audited; (*b*) there were no modifications to the auditor's report in the prior year related to census data; and (*c*) the auditor believes there is no significant risk of material misstatement due to incomplete or inaccurate census data from prior years.

Emphasis Point

Management of single-employer and cost-sharing OPEB plans is responsible for the preparation and fair presentation of financial statements, including completeness and accuracy of census data. Management is also responsible for the design, implementation, and maintenance of processes and controls relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to error or fraud.

Effective management processes and controls over census data separately identify the applicable risks of material misstatement related to the significant elements of census data for the various individual plan members because the risks may differ depending on a member's status (active or inactive). Accordingly, management of the plan would likely have different controls to address the applicable risks for active and inactive members. For example, service credits (periods of time worked) is likely to be a significant element of census data for active members because many OPEB plans require a certain minimum number of years of service (employment) as a condition for receiving OPEB. Conversely, service credits (periods of time worked) would not be a significant element of census data for inactive members because they are no longer earning service credit. Therefore, management would likely have more robust processes and controls related to active members for this element.

Effective plan management processes for the census data of a plan's active members include procedures to verify the underlying payroll and personnel records of the participating employer(s) to determine that the information provided is accurate and complete. For a cost-sharing OPEB plan, the frequency and extent of such verification may be determined by the plan based on the assessed level of risk for each participating employer.

The absence of effective controls by the plan to verify underlying payroll and personnel records of participating employer census data in a single-employer or cost-sharing OPEB plan is a deficiency in internal control over financial reporting. The plan auditor should follow the guidance contained in AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*), when evaluating the significance of control deficiencies and whether they should be communicated to those charged with governance.

Cost-Sharing OPEB Plans

14.57 The nature, timing, and extent of the auditor's substantive procedures over the census data and the underlying payroll and personnel records of participating employers (discussed in paragraphs 14.97–.100) will depend on (*a*) the assessed risks of material misstatement of the relevant financial statement elements, and (*b*) whether the auditor concludes that plan management has effective processes and controls in place to determine the completeness and accuracy of census data provided to the actuary. Ordinarily, it is more efficient for the auditor to take a controls-based approach to testing census data as well as the employers' underlying payroll and personnel records when management has effective processes and controls over the census data. The audit procedures performed by the plan auditor include selecting a representative group of contributing employers each year on a rotating basis for testing eligible employees' underlying payroll and personnel records.

14.58 When planning substantive procedures, the auditor of the cost-sharing OPEB plan uses judgment in determining which employers, if any, represent individually important employers to be tested annually and separated from the remaining population to be tested on a rotating basis. For example, an auditor may decide that any employer that constitutes more than 20 percent of the plan members will be considered individually important. Based on the composition of many plans, there may not be any individually important employers or they will likely be limited to one or two.

14.59 Once individually important employers have been identified, a risk-based approach may be used to determine which of the remaining employers to select for testing. The auditor may find the following qualitative factors helpful when selecting employers to test:

- The size of the employer in relation to a plan
- Past errors or control deficiencies of an employer
- Length of time since procedures under this section were last performed at an employer
- Whether there have been significant changes in an employer's workforce
- Results of internal analysis (analytical procedures) of employer information
- New or terminating employers to the plan
- Whether the financial statements of participating employers are audited and have received unmodified opinions

14.60 The frequency of procedures to be performed by the plan auditor at each employer will depend on the number of employers participating in the plan, the relative size of each employer, and the individual risk assessments. However, there often may be circumstances for which relatively small employers are not tested as part of such a cycle because they are considered to be inconsequential to the plan, both individually and when aggregated with other small employers not subject to testing.

14.61 The extent of testing depends on whether the plan has effective controls over census data reported by employers to the plan, including a plan management process for verifying the underlying payroll and personnel records of the participating employers to determine that the information provided is accurate and complete. Auditor judgment will be needed to determine the approach used to select the employers for the purpose of testing underlying payroll and personnel records.

14.62 For example, the auditor may develop an approach such that employers representing at least five percent of participating employers are tested at least once every five years. The number of participating employers that individually meet the five percent criterion will vary by plan and, in some cases, be limited to just a few. The auditor's approach for testing the remaining population of participating employers, which for some plans could number in the thousands, could be such that the remaining participating employers are tested to approximate a 10-year cycle.

Exhibit 14-1: Illustration of Previously Described Cost-Sharing Plan Auditor's Risk-Based Approach

Consider a plan with 500 participating employers for which the auditor has determined that plan management has effective controls to determine the completeness and accuracy of census data. The following is an illustration of the implementation of an auditor's risk-based approach:

- Based on the number and relative size of the participating employers, as well as a low assessed risk of material misstatement, the auditor determines that one employer constitutes more than 20 percent of total plan members (including both active and inactive members) and is individually important. Accordingly, this employer will be tested on an annual basis.
- Four employers are individually at least five percent of total plan members (including both active and inactive members), thus, the four employers will be tested to approximate a five-year cycle.
- The auditor then determines there are 72 very small employers that will likely never be tested because collectively they represent less than 2 percent of the total plan members (including both active and inactive members).
- The remaining employers (that is, 423) that individually represent less than 5 percent of total plan members (including both active and inactive members) will be tested to approximate a 10-year cycle.

14.63 Under such a risk-based approach, if the plan auditor cannot or does not perform census data testing at each employer selected for testing, such census data could be tested by the employer's auditor through an examination engagement in accordance with AT-C section 205, *Examination Engagements* (AICPA, *Professional Standards*). If such engagements are designed to test the assertions related to the completeness and accuracy of the census data and the selection of employers subject to the examination engagements are determined by the plan auditor, the plan auditor could then use such examination engagements as substantive evidence in lieu of the plan auditor directly performing the procedures. An example assertion regarding significant census data elements is provided in exhibit 14-2. An illustration of an examination report on a written assertion obtained from employer management is included in exhibit 14-3 of this chapter.

14.64 Even when employer auditors perform an examination engagement on census data, the plan auditor still has to determine if there is sufficient appropriate audit evidence over the completeness and accuracy of the census data underlying the plan's financial statement amounts by reviewing the attestation report and evaluating the competency of the other auditor.

14.65 It is important to understand the plan provisions when identifying significant elements of census data. Significant elements will likely include, at a minimum, those listed in the example management assertion. There will likely be additional significant elements based on the specific OPEB of a plan.

Exhibit 14-2: Example Assertion

The significant elements of census data reported to the [*Name of Retirement System*] for the [*Name of OPEB Plan*] during the year ended June 30, 20X6, were complete and accurate based on the criteria (plan provisions) included in [*identify applicable statutes or name of OPEB plan document*]. The significant elements reported to the [*Name of Retirement System*] for the [*Name of OPEB Plan*] were as follows:

Report	***Significant Elements***
[*Name of Report*] (for example, New Employee Enrollments)	[*List significant elements*] (for example, name, Social Security number, date of birth, hire date, gender, and marital status)
[*Name of Report*] (for example, Employer Transmission Report)	[*List significant elements*] (for example, name, position or job code, hours worked, years of service, employer contribution for period, and employee contribution for period)
[*Name of Report*] (for example, Employee Status Changes)	[*List significant elements*] (for example, name, Social Security number, and new job position)

Exhibit 14-3: Illustrative Attestation Report

Independent Accountant's Report

[*Appropriate Addressee*]

We have examined management's assertion that the significant elements of census data reported by City of Example, Any State to [*Name of Retirement System*] for the [*Name of OPEB Plan*] during the year ended June 30, 20X6, were complete and accurate based on the criteria included in [*identify applicable statutes or name of OPEB plan document*]. The significant elements of census data reported to [*Name of Retirement System*] for the [*Name of OPEB Plan*] were as follows:

Report	***Significant Elements***
[*Name of Report*] (for example, New Employee Enrollments)	[*List significant elements*] (for example, name, Social Security number, date of birth, hire date, gender, and marital status)
[*Name of Report*] (for example, Employer Transmission Report)	[*List significant elements*] (for example, name, position or job code, hours worked, years of service, employer contribution for period, and employee contribution for period)
[*Name of Report*] (for example, Employee Status Changes)	[*List significant elements*] (for example, name, Social Security number, and new job position)

City of Example's management is responsible for the assertion. Our responsibility is to express an opinion on management's assertion based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform the examination to obtain reasonable assurance about whether management's assertion is fairly stated, in all material respects. An examination involves performing procedures to obtain evidence about management's assertion. The nature, timing, and extent of the procedures selected depend on our judgment, including an assessment of the risks of material misstatement of management's assertion, whether due to fraud or error. We believe that the evidence we obtained is sufficient and appropriate to provide a reasonable basis for our opinion.

In our opinion, management's assertion that significant elements of census data reported by City of Example, Any State to [*Name of Retirement System*] for the [*Name of OPEB Plan*] during the year ended June 30, 20X6, were complete and accurate based on the criteria included in [*identify applicable statutes or name of OPEB plan document*] is fairly stated, in all material respects.

This report is intended solely for the information and use of City of Example [*Name of OPEB Plan*] and [*Name of OPEB Plan*]'s auditors and is not intended to be and should not be used by anyone other than the specified parties.

[*Practitioner's signature*]

[*Practitioner's city and state*]

[*Date of practitioner's report*]

14.66 As for the census data related to inactive members, the plan auditor can directly test records maintained by the plan to obtain sufficient appropriate evidence that the census data reported for inactive members to the actuary is complete and accurate.

Single-Employer OPEB Plans

14.67 In a single-employer OPEB plan, the risk-based approach to testing census data described previously is ordinarily not applicable. With only one employer, the plan's auditor can work with both the plan and the employer to obtain access to the underlying records of the active and inactive members. The plan auditor would also test the underlying data of a sample of members each year to obtain sufficient appropriate evidence that the census data reported to the actuary is complete and accurate. Such evidence may also be obtained through an examination engagement performed by the employer's auditor in accordance with AT-C section 205 as discussed in paragraphs 14.63–.66 of this chapter.

Census Data Considerations for Agent OPEB Plans

14.68 The financial statements of agent OPEB plans do not reflect any liabilities, deferred outflows of resources, deferred inflows of resources, or expenses that are based on actuarial information. It should be noted that for administrative purposes, the agent OPEB plan typically serves as the recordkeeper for census data reported by the employers and is responsible for engaging an actuary to perform an actuarial valuation to determine the net OPEB liability for each employer. Such amounts are provided to employers by the plan and are reflected only in the employer's financial statements.

14.69 In contrast to single-employer and cost-sharing OPEB plans, auditors of agent OPEB plans generally do not need to test census data at participating employers because the plan financial statements do not include any actuarial liabilities. However, agent OPEB plans are responsible for administering the plan, including the payment of benefits based on the census data reported by the employer. Accordingly, the focus of testing is generally on the accumulation and maintenance of census data by the plan based on the plan's role as the record keeper. Paragraphs 14.101–.102 address example audit procedures to consider for agent OPEB plans related to benefit payments. Note that the responsibilities for census data from the agent employer's perspective are discussed in part II of this chapter.

Alternative Measurement Method for Total OPEB Liability (fewer than 100 participants)

14.70 As discussed in paragraph 14.47, if an employer has fewer than 100 participants (active and inactive) as of the beginning of the OPEB plan's fiscal year, the total OPEB liability may be measured using the alternative measurement method discussed in paragraphs 56–57 of GASB Statement

No. 74. The audit guidance in this chapter does not address circumstances in which the plan uses the alternative measurement method (instead of an actuarial valuation) to measure the total OPEB liability. If such a situation exists, the auditor should perform appropriate audit procedures.

Plan Investments and Related Income

14.71 In addition to the requirements and considerations discussed in chapter 4 related to the auditor's risk assessment and understanding the entity, considerations specific to plan investments may include obtaining an understanding of investment policies, investment management arrangements, valuation techniques, and the relevant investment activities performed by plan management, trustee (or other asset custodian), and investment managers. Often, in governmental OPEB plans, the plan's investment provisions are dictated by state statutes and not a plan document. This section addresses plan investment-related issues specific to GASB Statement No. 74. Chapter 5 of this guide addresses other more general investment considerations.

Relevant Assertions

14.72 The relevant assertions for plan investments and investment income include the following:

a. Investments and investment transactions are initiated in accordance with the established investment policies and comply with plan provisions, laws, and regulations.

b. All investments are recorded and exist.

c. All investments are owned by the plan, free of liens, pledges, and other security interests or, if not free from security interest, it is identified and properly disclosed.

d. All investments are properly valued as of the plan's fiscal year-end.

e. All investment income (including net appreciation or depreciation) is accurately reported.

f. Investment disclosures, including the money-weighted rate of return on plan investments, are complete and accurate.

Examples of Identified Risks of What Can Go Wrong at the Relevant Assertion Level

14.73 The following are examples of identified risks of what can go wrong at the relevant assertion level relating to plan investments and investment income:

a. Investment information from the trustee (custodian) statements do not reconcile to the plan's records (trial balance) or financial statements.

b. Investment manager or subcustodial reports do not reconcile to trustee (custodian) reports.

c. Investment transactions are not recorded by the trustee (custodian) or are not recorded on a timely basis.

d. Investments and investment income (for example, alternative investments, private equity, and real estate) are not properly recorded as of the reporting date due to a lag (for example, 90 days) in reporting information by the investment managers.

e. Investments are not properly reported at fair value due to inappropriate valuation methodologies, mathematical errors in the application of the methodology, or inaccurate inputs.

f. Investment purchase and sale transactions are not properly authorized prior to initiation or are not in accordance with the investment policies, plan provisions, laws, and regulations.

g. Amounts due to (or due from) brokers for securities purchased or sold are not properly recorded.

h. Gains and losses on sales of investments are calculated incorrectly.

i. Allocated insurance contracts are not properly excluded from OPEB plan assets based upon contract terms.

j. The annual money-weighted rate of return is not properly calculated or disclosed.

Example Audit Procedures to Consider

14.74 General audit procedures for investments and investment income can be found in chapter 5 of this guide.

Contributions and Contributions Receivable

14.75 In addition to the requirements and considerations discussed in chapter 4 related to the auditor's risk assessment and understanding the entity, considerations specific to contributions may include obtaining an understanding of the types of contributions legally required to be remitted to the plan and the eligibility requirements, if applicable.

Relevant Assertions

14.76 The relevant assertions for contributions and contributions receivable are as follows:

a. Amounts received or due the plan for employer (including those from a nonemployer contributing entity) and active member contributions have been appropriately calculated, recorded, and disclosed in the financial statements in the proper period, in accordance with the plan provisions.

b. Amounts received or due the plan consist only of contributions pursuant to legal requirements and are recognized in full in the period the receivable arises.

c. Receivables arising from installment contracts are properly recorded in full in the period the receivable arises. If the receivable is recognized at its discounted present value, interest is properly accrued using the effective interest method.

d. Appropriate allowance has been made for uncollectible contributions receivable, if applicable.

e. Contributions include the amount, if any, of the age-adjusted premiums in excess of the blended premium rates for inactive members (implicit rate subsidy). See the emphasis point after paragraph 14.27.

Additional Considerations for Cost-Sharing OPEB Plans

f. Member census data used in determining employer and member contributions is complete and accurate.

g. Receivables due from withdrawing employers in a cost-sharing OPEB plan have been accurately calculated and recorded in the proper period.

Additional Considerations for Agent OPEB Plans

h. Employer (including nonemployer contributing entity) and member contributions are recorded in the appropriate employer's separate account.

Examples of Identified Risks of What Can Go Wrong at the Relevant Assertion Level

14.77 The following are examples of identified risks of what can go wrong at the relevant assertion level relating to contributions and contributions receivable:

a. Contributions are not recorded in the proper period (that is, when legally due).

b. Contributions (and benefit payments) exclude amounts for benefits paid directly by an employer from its own resources. See the emphasis point after paragraph 14.26.

c. Amounts received from inactive plan members receiving benefits are recorded as contributions (instead of as a reduction of benefit payments).

d. Contributions (and benefit payments) exclude amounts for the current period implicit rate subsidy (excess of age-adjusted premiums over blended rate premiums). See the emphasis point after paragraph 14.27.

e. Receivables arising from installment contracts are not properly recorded in full when the receivable arises. If a receivable is recognized at its discounted present value, interest is not properly accrued using the effective interest method.

f. Contributions receivable include amounts that are not due pursuant to legal requirements.

g. An appropriate allowance has not been made for uncollectible contributions.

Additional Considerations for Cost-Sharing OPEB Plans

h. Census data used in determining employer and member contributions is inaccurate or incomplete, resulting in improper shifting of costs among employers.

i. Employer contributions are not properly calculated based on the contractually required rate.

j. Amounts owed to the plan by employers who have withdrawn from the plan are incorrectly calculated.

Additional Considerations for Agent OPEB Plans

k. Employer (including nonemployer contributing entity) and employee contributions are recorded in the wrong employer separate account.

Example Audit Procedures to Consider

> ***Emphasis Point***
>
> As discussed in chapter 6, "Revenues and Receivables," of this guide, it is usually more efficient and effective to integrate the auditing of contributions with contributions receivable.

14.78 The following are examples of substantive procedures for auditing contributions and related contributions receivable for the plan:

a. Obtaining a subsidiary ledger (schedule) for all contributions and reconciling to the general ledger of the plan

b. Performing substantive analytical procedures on contributions disaggregated by type of contribution (for example, employers, nonemployer contributing entity, and members), as well as by individual employer

> ***Emphasis Point***
>
> When performing substantive analytical procedures, the auditor should follow the requirements in AU-C section 520, *Analytical Procedures* (AICPA, *Professional Standards*), to evaluate the reliability of data from which the expectation of recorded amounts or ratios is developed, taking into account the source, comparability, the nature and relevance of information available, and controls over the preparation. The auditor should also develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise, when combined, if applicable, with audit evidence from other audit procedures to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.

c. Confirming employer and active member contributions with the employer

d. Confirming nonemployer contributing entity contributions with the nonemployer contributing entity, if applicable

e. Selecting a sample of employer (including nonemployer contributing entity, if applicable) and member contributions and recalculating the contributions based on the required contribution rate or amount and tracing to cash received

f. Evaluating whether contributions include amounts for benefits paid directly by employers from their own resources (See the emphasis point after paragraph 14.26.)

g. Evaluating whether contributions exclude amounts received from inactive members receiving benefits

h. Reviewing criteria used by the plan in accruing employer (including nonemployer contributing entity, if applicable) and member contributions receivable and determining that all legally enforceable accruals have been recorded *i.* Evaluating whether contributions include the amount, if any, of the excess of age-adjusted premiums over the blended rate premium (implicit rate subsidy) (See the emphasis point after paragraph 14.27.)

j. Evaluating whether accruals for long-term receivables are in accordance with the installment contract (If the receivable is recognized at discounted present value, determine that interest was accrued using the effective interest method, unless use of the straight-line method would not produce significantly different results.)

k. Tracing the subsequent receipt of contributions receivable to supporting documentation

l. Evaluating the reasonableness of the plan's allowance for estimated uncollectible amounts, if applicable, based on testing collections subsequent to the date of the financial statements and reviewing the status of unpaid amounts

Additional Considerations for Single-Employer OPEB Plans

14.79 In lieu of confirming contributions with the employer, consider tracing employer and active member contributions to the employer's payroll records.

Additional Considerations for Cost-Sharing OPEB Plans

14.80 In addition to the audit procedures discussed in paragraph 14.78*a–l*, the following are additional examples of substantive audit procedures for auditing contributions to address the risk of cost shifting in the plan:

a. Obtaining a list of participating employers and testing its completeness by examining appropriate plan records; for example, a record of contributing employers, covered employee wages, and delinquency records could be obtained from the plan administrator

b. Obtaining a schedule of contributions received or receivable and agreeing the contributors to the listing of participating employers obtained for completeness

c. If contributions are based on actuarially determined amounts, testing the census data at employer locations discussed in paragraphs 14.97–.100

d. For employers who have withdrawn from the plan, recalculating the (termination) receivable based on the terms of the plan provisions or employer contract

e. Confirming census data directly with employers not selected for testing in accordance with item (*c*)

> ***Emphasis Point***
>
> Although confirming census data with participating employers is possible, such a procedure generally will not provide sufficient appropriate audit evidence for completeness and accuracy due to the ability for employers to underreport. Accordingly, tests of the employers' actual records are normally considered to be more appropriate. See paragraphs 14.97–.100 regarding the testing of census data maintained by the employer.

Additional Considerations for Agent OPEB Plans

> ***Emphasis Point***
>
> A significant administrative responsibility for agent OPEB plans is the proper maintenance of separate accounts for each participating employer. Accordingly, it is important to design substantive audit procedures that appropriately consider whether contributions are credited to the appropriate employer account.
>
> The employer auditor needs to obtain audit evidence that the fiduciary net position specific to the employer and included in the employer's financial statements is not materially misstated. Because the OPEB related elements, including fiduciary net position, are dependent on information maintained by the plan, significant interaction among the plan, participating employers, and their auditors is necessary to corroborate the OPEB amounts in employer financial statements.
>
> Appendix A, "Governmental Employer Participation in Agent Multiple-Employer Plans: Issues Related to Information for Employer Reporting," of chapter 13 presents two options for the plan auditor of a defined benefit pension plan to provide assurance services on information prepared by the plan related to fiduciary net position to assist participating employers and their auditors. OPEB plan auditors may want to consider the guidance in appendix A of chapter 13, adapted as appropriate for agent OPEB plans, when planning the audit of the financial statements to gain an understanding of the materiality differences in order to effectively coordinate the work performed for both of the engagements.
>
> Although the guidance in this appendix is integral to the audit of the employer's financial statements, this appendix is an *other auditing publication* and is nonauthoritative.

14.81 In addition to the audit procedures discussed in paragraph 14.78*a–j*, the following are additional examples of substantive audit procedures for auditing contributions for agent OPEB plans:

- *a.* Selecting a sample to test that contributions by individual employers have been credited to the appropriate employer's separate account in accordance with the provisions of the substantive plan
- *b.* Selecting a sample to test that contributions from the nonemployer contributing entity, if applicable, have been credited to the appropriate employer's separate account

Deposits With, and Receivables From, Insurance Companies and Other Service Providers

Relevant Assertions

14.82 The relevant assertions for deposits with, and receivables from, insurance companies (for example, premium stabilization reserves) and other service providers include the following:

- *a.* Deposits with or receivables from insurance companies are properly included in the financial statements and represent a valid deposit or receivable to the plan.

b. Deposits with or receivables from insurance companies have been appropriately calculated, recorded, and disclosed in the financial statements in the proper period, in accordance with the service provider agreement.

Examples of Identified Risks of What Can Go Wrong at the Relevant Assertion Level

14.83 The following are examples of identified risks of what can go wrong at the relevant assertion level relating to deposits with, and receivables from, insurance companies and other service providers:

a. Deposits or receivables required to be maintained by the insurance company are excluded from the financial statements.

b. Deposits with or receivables from insurance companies are not properly calculated or disclosed in the proper period.

c. Premium stabilization reserves are improperly recorded as premium payments (instead of as asset of the plan).

Example Audit Procedures to Consider

14.84 The following are examples of substantive procedures for auditing deposits with, and receivables from, insurance companies and other service providers for the plan:

a. Reviewing supporting documents and agreements with insurance companies and other service providers reflecting the requirements for such deposits

b. Confirming amounts with insurance companies and other service providers

c. Testing the accuracy of the amounts, as well as the subsequent receipts or disbursements

Benefit Payments and Benefits Payable

14.85 In addition to the requirements and considerations discussed in chapter 4 related to the auditor's risk assessment and understanding the entity, considerations specific to benefit payments and benefits payable may include obtaining an understanding of the types of benefits covered by the plan, the eligibility requirements, and the methods of calculating the benefits.

14.86 As discussed in the emphasis point after paragraph 14.49, the substantive plan may, and often does, differ from the written documents (including state statutes and the plan document). Accordingly, other information also should be taken into consideration in determining the benefits to be provided, including communications between the employer and plan members (active and inactive members) and an established pattern of practice with regard to the sharing of benefit-related costs with inactive members. Accordingly, the claims administration and claims adjudication process is complex for self-insured plans; therefore, the risk of material misstatement associated with claims is inherently higher. Obtaining a sufficient understanding of a plan's internal controls over claim payments is critical to assessing the risks of material misstatement of the financial statements, whether due to error or fraud.

> ***Emphasis Point—Confidentiality or Indemnification Agreements***
>
> In certain instances (for example, testing claims at a third-party claims processor), a third-party administrator will request that the auditor enter into a confidentiality or an indemnification agreement signed by the auditor, third-party administrator, and plan sponsor relating to the access of information for claims testing. Auditors are cautioned to carefully review these agreements because the auditor may not agree with certain language in the agreement, resulting in delays in completing the audit while mutually agreeable language is determined. Many of the representations and indemnifications in the agreements are very broad and, generally, require that the auditor hold the claim processor harmless from any actual or threatened action arising from the release of information without limitation of liability. In addition, the agreements may require the auditor to hold the client harmless, as well. Holding the client harmless will most likely contradict provisions in the engagement letter between the auditor and client because the AICPA independence rules prohibit this type of indemnification. Before entering into any confidentiality agreement, it may be necessary to have the agreement reviewed by the auditor's legal counsel. If the auditor is unable to obtain access to records as a result of not signing a confidentiality agreement, a scope limitation could result. See AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report* (AICPA, *Professional Standards*), for the reporting requirements when the auditor concludes that a modification to the auditor's opinion on the financial statements is necessary due to a limitation on the scope of the audit.

Relevant Assertions

14.87 The relevant assertions related to benefit payments and benefits payable include the following:

Health Care Benefits (Self-Insured)

a. Benefit payments (including those paid directly by the employer or a third-party administrator) have been calculated and paid in accordance with substantive plan provisions, member elections, and related documents.

b. Benefit payments (including those paid directly by the employer or a third-party administrator) are made only to persons entitled to them (that is, payments are not being made to deceased beneficiaries or persons other than eligible members and beneficiaries).

c. Unpaid benefits due under the plan are recorded as liabilities and benefits payable are valid liabilities of the plan.

d. Amounts have been accurately calculated, recorded, and disclosed in the financial statements in the proper period.

e. Reimbursement from stop-loss insurance has been properly accrued.

Health Care Benefits (Purchase of Insurance)

f. Benefit payments (premiums) are recognized based on age-adjusted premiums, as opposed to a blended rate premium with active employees (implicit rate subsidy). See the emphasis point after paragraph 14.27.

g. Premiums are paid in accordance with the substantive plan provisions and member elections, and are properly authorized.

h. Premiums are paid in accordance with agreements with the insurance entity.

i. Premiums are accurately calculated, recorded, and disclosed in the financial statements in the proper period.

j. Unpaid premiums due under the plan are recorded as liabilities, and benefits payable are valid liabilities of the plan.

Additional Considerations for Agent OPEB Plans

k. Benefit payments to members have been made from the appropriate employer's separate account.

Examples of Identified Risks of What Can Go Wrong at the Relevant Assertion Level

14.88 The following are examples of identified risks of what can go wrong at the relevant assertion level relating to benefit payments:

> ***Emphasis Point***
>
> Benefit payments include claims payments for plans that are self-insured and insurance premiums for plans that purchase insurance.

a. Benefit payments are incorrectly calculated or not in accordance with the member's benefit election.

b. Benefit payments are not in accordance with the provisions of the substantive plan.

c. Benefit payments (and contributions) exclude payments made directly by the employer from its own resources. See the emphasis point after paragraph 14.26.

d. Benefit payments (and contributions) exclude amounts for the current period implicit rate subsidy (excess of age-adjusted premiums over blended rate premiums). See the emphasis point after paragraph 14.27.

e. Benefit payments are made to or on behalf of a member or beneficiary who is not eligible to receive benefits.

f. Benefit payments are not reduced (offset) by amounts paid by inactive members receiving the benefits.

g. Benefits payable to members and claims payable to providers are not properly calculated or accrued in the proper period.

h. Stop loss reimbursements, refunds, rebates, or subsidized amounts due the plan are not properly accrued.

Specific to Self-Insured Benefits

i. Plan provisions are improperly applied either when installed or maintained in the claims processor's system.

j. Claim payment details are incorrectly submitted or entered in the claims clearinghouse or claims processing system.

k. Payments made to claims processors for claims paid to members are not tracked, are improperly recorded, and are not in accordance with the provisions of the substantive plan or negotiated rates.

l. Fictitious or duplicate claim payments are recorded.

m. Fees associated with third-party claims administrators are reported with benefit payments and not as administrative expenses.

n. Benefit payments for inactive members have not been properly segregated from payments for active members and in the month of retirement active members were not properly recategorized as inactive members.

Specific to Purchase of Insurance

o. Insurance premiums are not properly recorded or classified.

p. Insurance premiums are not calculated in accordance with the agreement with the insurance entity (for example, in arrangements when the plan sponsor bills the insurance entity or for experience-rated contracts).

Emphasis Point

It is important for the plan auditor to assess whether there is a fraud risk associated with benefit payments depending on the specific facts and circumstances of internal controls relative to financial reporting or misappropriation of assets. Benefit payments may be susceptible to fraud, especially when there is a lack of segregation of duties—making it possible for an employee to divert unauthorized benefit payments to another account outside the plan. An employee may have the ability to initiate, authorize, and record or change a transaction or may have custody of assets within the process such that he or she is able to perpetrate and conceal a fraud, causing duplicate, excess or fictitious benefit payments, or withdrawals to be recorded. If the auditor concludes that a fraud risk could exist, the auditor is required to design the nature, timing, and extent of audit procedures in response to that risk.

Additional Considerations for Agent OPEB Plans

q. The member's claim payment is made from the wrong employer's separate account.

Example Audit Procedures to Consider

14.89 As discussed in chapter 8, "Expenses or Expenditures and Liabilities," of this guide, because expense-expenditure and liability transactions are closely related, many audit procedures satisfy the objectives of both types of accounts at the same time. The following are examples of substantive procedures for auditing benefit payments and benefits payable:

a. Obtaining a subsidiary ledger (schedule) of all benefit payments (for example, benefits paid directly to members, purchase of insurance, payments to health care providers for self-insured benefits, and purchase of allocated insurance contracts) by type for the current plan year and reconciling to the general ledger of the plan

> ***Emphasis Point***
>
> Due to the different risks associated with the various types of payments, segregating the schedule of benefit payments in various ways (for example, by type, by newly retired in the current year from existing retirees as well as by employee class) allows the auditor to select appropriate samples for members receiving benefit payments.

b. Performing substantive analytical procedures on benefit payments disaggregated by type, such as by type of benefit or by month (The plan provisions and census data may serve as a basis for developing expectations.)

> ***Emphasis Point***
>
> When performing substantive analytical procedures, the auditor should follow the requirements in AU-C section 520 to evaluate the reliability of data from which the expectation of recorded amounts or ratios is developed, taking into account the source, comparability, and the nature and relevance of information available, as well as controls over the preparation. The auditor should also develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise, when combined, if applicable, with audit evidence from other audit procedures to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.
>
> Because of the lack of predictability of payment for certain types of benefits (for example, self-insured health claims and death benefits), it may be difficult to obtain evidence with respect to specific assertions associated with benefit payments solely through the performance of substantive analytical procedures.

Health Care Benefits (Self-Insured)

c. Inquiring of plan management about the status of denied claims and, if deemed necessary, testing a sample of denied claims and evaluating whether the selected claims were appropriately denied

d. Obtaining and testing a reconciliation of the claims data file for the period to wire transfer information or bank statements

> ***Emphasis Point***
>
> Some reconciliation variances may be due to
>
> - claims adjustments included in the data file, but the refund is pending or was received after the audit period. (It may be helpful to determine how adjustments can be identified [often a change in the claim number].)
> - charges that may not be included on one of the files being compared.
> - refunds and rebates that may not be reflected in the claims data (for example, stop-loss reimbursements, refunds received after the audit period, or Pharmacy Benefit Manager rebates).

e. Selecting a sample of claims from the schedule of benefit payments and performing the following procedures:

i. Determining whether the member or beneficiary was eligible on the date of service in accordance with the provisions of the substantive plan (for example, whether the payee meets the eligibility requirements)

> ***Emphasis Point***
>
> In evaluating eligibility, consider examining evidence of age and employment history data, as well as comparing employment dates and credited service (taking into consideration interrupted service or service with multiple employers within the plan) based on the provisions of the substantive plan.

ii. Verifying claim submission for type and amount of claim, as well as the propriety of required approvals, if applicable (For example, approvals may be required by the plan administrative committee for large or disputed claims.)

iii. Verifying service provider statements or other evidence of service rendered (for example, provider bill or data feed from claims clearinghouse)

iv. Verifying the accuracy of the claim payment based on the plan provisions and related documents (for example, identifying whether the claim was appropriately adjusted, if applicable)

> ***Emphasis Point***
>
> Testing the accuracy of a claim payment can be challenging. Documentation supporting claim payments is generally maintained by the claims processor and, to protect confidentiality, may only be available on-site at the claims processor. Auditors may consider the need to involve a claims specialist to assist in testing claims payments.

v. Comparing the benefit payment amount with the amount included in the cash disbursement records or trustee reports

vi. For benefit payments received directly by members, verifying receipt of the benefit payment if applicable

> ***Emphasis Point***
>
> Verifying the receipt of the benefit payment can be accomplished in a number of ways, such as confirming payment of benefits, comparing canceled checks with the plan's cash disbursement records (including review of the endorsement), or comparing the payee name or account name on electronic funds transfers with the member or beneficiary name, or confirming directly with selected members, service providers, and beneficiaries or with other appropriate documents. In addition, the auditor may want to consider inquiring about

the existence and frequency of member complaints. Long-outstanding checks may be indicative of duplicate payments or deceased or missing members or beneficiaries.

vii. Agreeing the name, type of benefit, and amount to a member data list to determine that the member or beneficiary was properly classified in the retired category by the actuary

Emphasis Point

As discussed in paragraph 14.56, the substantive procedures over census data are ordinarily based on a concept that focuses on testing incremental changes to the census data file during the 12-month period immediately preceding the actuarial valuation date when valuations are done annually. These procedures would ordinarily cover the census data reported to the plan during 1) the year immediately preceding the actuarial valuation when the actuarial valuation is performed on an annual basis, or 2) the two-year period immediately preceding the actuarial valuation when the actuarial valuation is performed on a biennial basis. For example, if a plan has a fiscal year-end of June 30, 20X5, and uses a beginning-of-the-year actuarial valuation of July 1, 20X4 (which is rolled forward to the plan's fiscal year-end of June 30, 20X5), the focus of the procedures would ordinarily be over the census data reported to the plan during the year ended June 30, 20X4. In this example, it would not be possible to trace the relevant census data from the sample used to test current-year benefit payments in the previous procedure to the census data file because the reporting periods are different. In this circumstance, the auditor may consider tracing the sample from the prior-year testing of benefit payments to the census data file used to measure the net OPEB liability for the current year.

In contrast, if the plan uses an end-of-the-year valuation to measure the net OPEB liability as of June 30, 20X7, the auditor would be able to trace the relevant census data from the sample used to test current-year benefit payment to the census data file.

f. Obtaining and reviewing applicable SOC 1 reports for processes outsourced to third-party claims processors on behalf of the plan administrator, as well as evaluating the need to obtain additional SOC 1 reports for identified subservice organizations and processes and controls carved out

Emphasis Point

In some circumstances, benefit disbursements are made by a third party, such as a claims processor or other service provider. In these circumstances, it is important for the auditor to obtain an understanding of the internal control procedures of the third party. This can be satisfied either through obtaining a type 2 SOC 1 report or applying appropriate auditing procedures at the service organization. By design, SOC 1 reports provide the plan administrator and the plan's auditors with evidence regarding design and implementation (type 1) and operating effectiveness (type 2) of controls at a service organization but not substantive audit evidence. Although a type 2 SOC 1 report may be used to reduce substantive procedures, the report is not designed to provide a basis for assessing control risk sufficiently low to eliminate the need for performing any substantive tests.

g. Evaluating the adequacy of the controls over the installation and maintenance of key plan information, such as benefit provisions, employee information, providers, and rate structure at the service provider

h. For plans with stop-loss coverage, evaluating whether specific deductibles or aggregate deductibles (commonly referred to as aggregate attachment points) have been reached (because the insurance entity is liable for amounts in excess of the specific deductible or aggregate attachment points)

i. Determining that fees associated with third-party claims administrators are reported as administrative expense (that is, separate from benefit payments)

j. Verifying the criteria used by the plan to record benefit payments and determining that the claim payments have been properly recorded

Health Care Benefits (Purchase of Insurance)

k. Selecting a sample of beneficiaries from the schedule of benefit payments and performing the following procedures:

i. Determining whether the member or beneficiary was eligible on the date of service in accordance with the provisions of the substantive plan (for example, whether the payee meets the eligibility requirements)

Emphasis Point

In evaluating eligibility, consider examining evidence of age and employment history data; comparing employment dates and credited service (taking into consideration interrupted service or service with multiple employers within the plan) based on the plan provisions.

ii. Verifying the premium paid based on the health benefit plan selected by the participant and the applicable premium rate in the insurance contract

iii. Agreeing the name, type of benefit, and amount to a member data list to determine that the member or beneficiary was properly classified in the retired category by the actuary

l. Comparing the number of eligible participants, as shown by the plan's eligibility records, with the premium computation and tracing the applicable premium rates to the insurance contracts

m. Recalculating premiums paid by multiplying the number of eligible participants by the premium rate in the insurance contract

> ***Emphasis Point***
>
> Employers often purchase health care insurance for active employees and inactive employees based on blended premium rates for all covered individuals (that is, all covered individuals participate in one experience pool). In this circumstance, benefit payments reported by the plan should be based on the age-adjusted premiums for the inactive employees, not the blended premium rates. In this circumstance, auditors will need to obtain sufficient and appropriate audit evidence to evaluate the accuracy of the age-adjusted premiums.

n. Comparing periodic premiums paid between years, including subsequent payments, and investigating the reasons for significant changes

o. Considering the change in premiums paid between periods by comparing to the increase or decrease in the number of participants

p. Confirming total premiums paid during the year, premiums payable to the insurance company, and other obligations and assets of the plan at year-end directly with the insurance entity

Death, Disability, and Related Benefits

q. Selecting a sample of death and disability payments and performing the following procedures:

i. Verifying the participant's or beneficiary's eligibility (that is, whether the payee meets the plan's eligibility requirements) by examining evidence of employment history data and comparing employment dates, credited service, earnings, and any employee contributions with payroll or other appropriate records

> ***Emphasis Point***
>
> For long-term disability benefits, consider examining a written determination by a doctor of whether the participant can perform his or her occupation or any occupation and reading doctor notes and participant questionnaires, as well as examining the determination of functional capacity.

ii. Examining a copy of the death certificate and beneficiary form, physician's statement, and other appropriate documents

iii. Recomputing benefits based on the provisions of the substantive plan, benefit level elected, and pertinent service or salary history

iv. Verifying payment made to beneficiary (See the emphasis point after item *e* (vii).)

v. For death benefits, examining the member data list to determine the member's or beneficiary's name was properly removed from the census data

Additional Considerations for Agent OPEB Plans

> ***Emphasis Point***
>
> A significant administrative responsibility for agent OPEB plans is the proper maintenance of separate accounts for each participating employer. Accordingly, it is important to design substantive audit procedures that appropriately consider whether benefits are made from the appropriate employer account.
>
> Appendix A of chapter 13 presents two options for the plan auditor of a defined benefit pension plan to provide assurance services on information prepared by the plan related to fiduciary net position to assist participating employers and their auditors. OPEB plan auditors may want to consider the guidance in appendix A of chapter 13, adapted as appropriate for agent OPEB plans, when planning the audit of the financial statements to gain an understanding of the materiality differences in order to effectively coordinate the work performed for both of the engagements.
>
> Although the guidance in this appendix is integral to the audit of the employer's financial statements, this appendix is an *other auditing publication* and is nonauthoritative.

r. Selecting a sample of benefit payments to test that the benefit payment has been recorded as a disbursement from the appropriate employer's separate account

Investment and Administrative Expenses and Related Liabilities

Relevant Assertions

14.90 The relevant assertions for investment and administrative expenses and related liabilities include the following:

a. Investment management and performance fees and administrative expenses have been accurately calculated and reported in the financial statements in the proper period.

b. Reported liabilities represent amounts unpaid and due as of the fiscal year-end.

c. Amounts payable are valid liabilities of the plan.

Examples of Identified Risks of What Can Go Wrong at the Relevant Assertion Level

14.91 The following are examples of identified risks of what can go wrong at the relevant assertion level relating to investment and administrative expenses and related liabilities:

a. Unpaid administrative fees (for example, for actuaries, auditors, trustees, claim processors, insurance companies, or legal counsel) are incomplete, invalid, or not accurately calculated and reported in the proper period.

b. Investment management and performance fees are incomplete, invalid, or not appropriately calculated and reported in the proper period.

c. Investment and administrative expenses are not properly classified in the statement of changes in fiduciary net position.

Example Audit Procedures to Consider

14.92 Chapter 8 of this guide provides auditing considerations related to liabilities and expenses. However, specific to OPEB plans, the following are examples of substantive procedures for auditing investment and administrative expenses and related liabilities:

a. Performing substantive analytical procedures on recurring types of administrative expenses

> ***Emphasis Point***
>
> When performing substantive analytical procedures, the auditor should follow the requirements in AU-C section 520 to evaluate the reliability of data from which the expectation of recorded amounts or ratios is developed, taking into account the source, comparability, the nature and relevance of information available, and controls over the preparation. The auditor should also develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise, when combined, if applicable, with audit evidence from other audit procedures to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.

b. Selecting a sample of investment managers and recalculating the (base) investment management fee and the performance (incentive) fee based on the investment agreement, as well as determining whether the appropriate amount was accrued as of year-end

> ***Emphasis Point***
>
> The calculation of a performance (incentive) fee is specific to the terms of the investment agreement, but generally, the calculation should be as if the investment assets and related liabilities are liquidated at their fair value as of the date of the statement of fiduciary net position.

c. Evaluating whether investment and administrative expenses are properly classified in the statement of changes in fiduciary net position

> ***Emphasis Point***
>
> As required by paragraph 30 of GASB Statement No. 74, all investment-related costs should be reported as investment expense if they are separate from (*a*) investment income and (*b*) the administrative expenses of the OPEB plan. This includes investment management and custodial fees and all other significant investment-related costs, such as the allocable share of salary and fringe benefits for employees that spend a significant portion of time on tasks related to investments.

Total OPEB Liability, Net OPEB Liability, and Related Disclosures for Single-Employer and Cost-Sharing OPEB Plans

14.93 In addition to the requirements and considerations discussed in chapter 4 related to the auditor's risk assessment and understanding the entity, considerations specific to total OPEB liability, net OPEB liability, and related disclosures may include obtaining an understanding of the actuary's objectives, scope of work, methods and assumptions, and consistency of application.

Relevant Assertions

14.94 The relevant assertions related to the total OPEB liability, net OPEB liability, and related disclosures for single-employer and cost-sharing OPEB plans include the following:

- *a.* Member census data used in calculating the actuarially computed total OPEB liability is complete and accurate.
- *b.* Actuarial assumptions in computing the total OPEB liability are in accordance with GASB Statement No. 74 requirements and the Actuarial Standards of Practice.
- *c.* The total OPEB liability, fiduciary net position, and net OPEB liability have been properly calculated and disclosed in accordance with GASB Statement No. 74 requirements.

Examples of Identified Risks of What Can Go Wrong at the Relevant Assertion Level

14.95 The following are examples of identified risks of what can go wrong at the relevant assertion level relating to total OPEB liability, net OPEB liability, and related disclosures for single-employer and cost-sharing OPEB plans:

- *a.* The actuary does not have the appropriate qualifications or related experience to perform the valuation.
- *b.* Members (or member groups in a cost-sharing OPEB plan) are inappropriately excluded from or included in the census data.
- *c.* Census data reported to the plan by the participating employer(s) does not reconcile to (agree with) the employer's payroll and personnel records, causing errors in the computation of total OPEB liability.
- *d.* The plan does not properly accumulate (maintain) the census data based on information reported by the employer(s) for active members as well as activity for census data controlled by the plan for inactive members, causing errors in the computation of total OPEB liability.
- *e.* The plan's actuary uses incomplete (missing) or incorrect census data causing errors in the computation of total OPEB liability.
- *f.* The plan's actuary uses inappropriate assumptions or actuarial methods that are not in conformity with GASB Statement No. 74 and the Actuarial Standards of Practice causing errors in the computation of total OPEB liability. Examples of inappropriate assumptions or actuarial methods include the following:
    - i. Using an actuarial cost method other than entry age normal for computing the total OPEB liability

ii. Using a long-term rate of return that does not reflect the future expected rate of return on plan investments based on investment strategy and target asset allocations

iii. Using a health care trend rate that does not reflect the future expected increases in per capita health claims rates over time due to factors such as medical inflation, utilization, plan design, and technology improvements

iv. Using a cost change rate that does not reflect the future expected increases of other costs such as the cost of life insurance and long-term care insurance

v. Not properly considering current and future participation rates of members in projection of benefits

Emphasis Point

For plans that require some form of contribution to maintain coverage, some eligible individuals may elect not to be covered, particularly if they have other coverage available. In accordance with Actuarial Standard of Practice No. 6, empirical data on plan participation, where available and credible, should be considered when selecting the participation assumption for future retirees. When developing the participation rates, the actuary should consider how plan eligibility rules, plan choices, or retiree contribution rates have changed over time.

Furthermore, plan participation may be different in the future due to participants' response to changes in retiree contribution levels and plan choices (for example, Medicare+Choice). For plans that anticipate changes in retiree contributions, the actuary should consider the appropriateness of participation rates that vary over the projection period for both current and future retirees. The actuary should consider plan eligibility rules governing dropping coverage and subsequent reenrollment when selecting participation rates.

vi. Using inappropriate cash flow projections when calculating the discount rate

vii. Using mortality assumptions that do not properly reflect expected future improvement in mortality rates

g. Projected benefit payments used in the actuarial valuation do not include all benefits to be provided to active and inactive members in accordance with the benefit terms that are in force at the plan's fiscal year-end, causing the incorrect computation of the total OPEB liability.

h. Projected benefit payments used in the actuarial valuation do not include the effects of automatic postemployment benefits, ad hoc benefit changes that are substantively automatic, or projected salary changes, causing the incorrect computation of the total OPEB liability.

i. Projected benefit payments used in the actuarial valuation do not include taxes or other assessments expected to be imposed on benefit payments, causing the incorrect computation of the total OPEB liability.

j. Projected benefit payments are not based on claims costs, or age-adjusted premiums approximating claims costs, causing the incorrect computation of the total OPEB liability.

k. Plan amendments or changes in benefit terms have not been properly included or excluded as of the plan's fiscal year-end. See the emphasis point on a substantive plan after paragraph 14.49.

l. The fiduciary net position used in calculating the net OPEB liability is not the same as the fiduciary net position reported in the plan's statement of fiduciary net position.

Example Audit Procedures to Consider

14.96 The following are examples of substantive procedures for auditing total OPEB liability; net OPEB liability, and related disclosures for single-employer and cost-sharing OPEB plans:

a. Obtaining the actuarial valuation report used to measure the total OPEB liability as of the plan's fiscal year-end based on GASB Statement No. 74

> ***Emphasis Point***
>
> Plans often have different actuarial valuations performed for accounting purposes (for example, accounting pursuant to GASB Statement No. 74) and funding purposes (for example, actuarially determined contributions). It is important the auditor receive a complete actuarial valuation report that has been prepared for accounting purposes that includes an actuarial certification.

b. Evaluating the professional qualifications of the actuary, including his or her competence, capabilities, and objectivity as required by paragraph .08 of AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*) (If the actuary is not known to the auditor, consider other factors that might provide information regarding the actuary's qualifications, such as [i] the actuary's membership in a recognized professional organization, [ii] the number and types of OPEB plans served, including years of experience, and [iii] the opinion of other actuaries whom the auditor knows to be qualified regarding the actuary's professional qualifications.)

> ***Emphasis Point***
>
> Paragraph .12 of AU-C section 300, *Planning an Audit* (AICPA, *Professional Standards*), states the auditor should consider whether specialized skills are needed in performing an audit. Careful consideration of the engagement team skills, knowledge, and experience as it relates to actuarial information is critical in such engagements. If specialized skills are needed, consider using an auditor specialist (for example, an actuary) in evaluating the appropriateness of the actuarial valuation and the measurement of the total OPEB liability.

c. Inquiring about the nature of any interests or relationships the actuary may have with the plan or employer(s) that may create threats to the actuary's objectivity (for example, financial interests, business or personal relationships, or the provision of other services) and any applicable safeguards

> ***Emphasis Point***
>
> Although safeguards cannot eliminate all threats to the objectivity of an actuary, threats such as intimidation by management may be of less significance to a specialist engaged versus employed by the plan or plan administrator. This evaluation of objectivity may be accomplished by the auditor asking management to have the actuary describe in writing interests and relationships, if any, that may exist and that may appear to impair the objectivity of the actuary.

d. Reading the actuarial certification for potential exclusions from the scope of the actuary's work or for qualifications on the actuary's certification relating to actuarial methods, actuarial assumptions, or census data

e. Inquiring of management and the actuary whether the actuarial valuation considers all pertinent provisions of the substantive plan, including any changes or amendments to the plan or other events or considerations affecting the actuarial calculations that are effective as of the plan's fiscal year-end (See the emphasis point after paragraph 14.49 regarding determining the substantive plan.)

> ***Emphasis Point***
>
> Other considerations include whether the valuation includes or does not include the impact of the Medicare subsidy provided by the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 as well as taxes and other assessments.

f. Determining whether the actuarial valuation was performed as of a date within 24 months of the plan's fiscal year-end

g. Evaluating whether the methods and assumptions used in determining the total OPEB liability and actuarially determined contributions information are in accordance with GASB Statement No. 74 and Actuarial Standards of Practice (See examples of identified risks of what can go wrong related to actuarial assumptions in paragraph 14.95*f*.)

h. If the actuarial valuation was performed as of a date prior to the plan's fiscal year-end, reviewing the appropriateness of the update procedures to roll forward the total OPEB liability to the plan's fiscal year-end and determining whether all significant known events have been properly included

i. Testing the reliability and completeness of the member census data used (See paragraphs 14.97–.100 for specific procedures.)

j. Evaluating the propriety of the long-term expected rate of return used in the calculation of the discount rate

Emphasis Point

Paragraph 52 of GASB Statement No. 74 requires the long-term expected rate of return used in the calculation of the discount rate to be forward-looking and be based on the appropriate expected long-term rate of return considering target asset allocations. It is often developed using a building-block approach based on portfolio modeling. Plan management should evaluate the appropriateness of the rate each year based on current information. When evaluating the reasonableness of management's assumption, the auditor is cautioned to avoid supporting the reasonableness of this assumption solely based on retrospective analysis of historical investment returns.

k. Evaluating whether the discount rate is reasonable and is a single rate in accordance with GASB Statement No. 74

i. Obtaining the discount rate calculation and supporting schedules as of the plan's fiscal year-end

ii. Testing the mathematical accuracy of the discount rate calculation and supporting schedules

iii. Performing the following procedures on the components[12] of the projection of the plan fiduciary net position (that is, net position roll forward):

(1) Tracing beginning plan fiduciary net position to audited plan financial statements

(2) Comparing employer (including nonemployer contributing entity, if applicable) and plan member contributions in (future) year one to actual contributions in current year audited plan financial statements

(3) Evaluating reasonableness of projected future employer (including nonemployer contributing entity, if applicable) and plan member contributions based on age demographics of active plan members (As active plan members retire, projected future contributions will decrease dramatically as employer and plan member contributions related to future employees are excluded.)

(4) Evaluating appropriateness of projected future employer (including nonemployer contributing entity, if applicable) contributions based on the criteria in paragraph 42 of GASB Statement No. 74

[12] Components would include projected beginning fiduciary net position by year, projected contributions for the year, projected benefit payments for the year, projected investment return for the year, projected administrative expenses for the year, and ending fiduciary net position.

> ***Emphasis Point***
>
> As discussed in paragraphs 50–51 of GASB Statement No. 74, plan management should apply professional judgment to project cash flows for contributions from the employers and nonemployer contributing entities in circumstances in which (*a*) those contribution amounts are established by statute or contract, or (*b*) a formal, written policy related to those contributions exists. Plan management's application of professional judgment should consider the most recent five-year contribution history (to determine the degree of adherence to preceding [*a*] and [*b*]) of the employers and nonemployer contributing entities as a key indicator of future contributions from those sources and should reflect all other known events and conditions.
>
> In circumstances in which there is a statute or formal written policy that requires increasing contribution rates in future years, plan management's application of professional judgment will likely be difficult in determining whether to consider such funding in projected cash flows for contributions. Further, in evaluating the appropriateness of plan management's judgment about future contributions, the auditor considers the most recent five-year history and evaluates the likelihood that the increased contribution rates will be made. In evaluating the likelihood that increased contributions will be made, the auditor may consider whether the government has a history of amending similar statutes and written policies due to inability to make the required contributions.
>
> In circumstances other than those described in (*a*) and (*b*), the amount of projected cash flows for contributions from employers and nonemployer contributing entities should be limited to an average of contributions from those sources over the most recent five-year period (percentage of covered payroll contributed or percentage of actuarially determined contributions made) and may be modified based on consideration of subsequent events.

(5) Comparing (future) year-one benefit payments to actual benefit payments in the current year audited plan financial statements

(6) Evaluating reasonableness of projected future benefit payments based on age demographics of current plan members, projected retirement dates, projected benefit payments based on the applicable benefit formula, and mortality assumptions used in the actuarial valuation

(7) Recalculating investment earnings by year based on the long-term expected rate of return

iv. Performing the following on the calculation of actuarial present values of the projected benefit payments:

(1) Tracing beginning fiduciary net position for each year presented and projected benefit payments to net position roll forward tested previously

(2) For future years in which beginning fiduciary net position is sufficient to pay projected benefits for the respective year, determining whether the

projected benefit payments were properly discounted using the long-term expected rate of return on plan investments

(3) For future years in which beginning fiduciary net position is not sufficient to pay projected benefits for the respective year, determining whether the projected benefit payments were properly discounted using an appropriate 20-year AA municipal bond yield or index rate as of the plan fiscal year-end

(4) Recalculating the single (blended) discount rate

l. Verifying the fiduciary net position used in calculating the net OPEB liability is the same as the fiduciary net position reported in the plan's statement of fiduciary net position

m. Recomputing the calculation for the net OPEB liability, which is the total OPEB liability less the plan fiduciary net position as of the plan's fiscal year-end

Census Data

14.97 In addition to the requirements and considerations discussed in chapter 4 related to the auditor's risk assessment and understanding the entity, considerations specific to census data may include obtaining an understanding of the following:

a. Assumptions used by the actuary in changing census data, if applicable

b. Plan's processes and controls used by management to accurately and completely maintain records for significant elements of census data for all plan members (active members, inactive members entitled to but not yet receiving benefits, and inactive members currently receiving benefits)

Additional Considerations for OPEB Plans Under Separate Governance Structures

c. Plan's processes and controls used by the plan's management to accumulate census data reported by the employers, including enrollment, status changes, benefits selected, and employer (payroll) transmission reports

> ***Emphasis Point***
>
> The processes for accumulating census data reported by employers for many plans are highly automated with little or no manual intervention. Accordingly, the auditor may determine that it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive audit procedures. In such cases, the plan's controls over such risks are relevant to the audit, thus, the auditor should obtain an understanding of the controls and consider testing the operating effectiveness.

d. For the employer in the single-employer OPEB plan or the employers selected to test in a cost-sharing OPEB plan (discussed in paragraphs 14.57–.62):

   i. Employers' processes for enrolling new employees and reporting status changes to the plan

   ii. Employers' payroll accounting systems and systems of reporting information included in the employer (payroll) transmission reports submitted to the plan

14.98 For single-employer and cost-sharing OPEB plans when the plan and participating employer(s) have different governance structures (discussed in paragraph 14.15), plan auditors should follow the guidance "Example Audit Procedures to Consider for Single-Employer and Cost-Sharing Plans" included in chapter 13 (paragraphs 13.90–13.93), adapted as appropriate for OPEB plans.

Emphasis Point

As discussed in paragraph 14.56, the substantive procedures over census data are ordinarily based on a concept that focuses on testing incremental changes to the census data file during 1) the year immediately preceding the actuarial valuation date when the actuarial valuations are performed on an annual basis, or 2) the two-year period immediately preceding the actuarial valuation when the actuarial valuations are performed on a biennial basis. These procedures would ordinarily cover the incremental census data accumulated by the plan (that is, changes to the census data file) during the applicable period.

For example, if a plan has a fiscal year-end of June 30, 20X7, and uses a beginning of the year actuarial valuation of July 1, 20X6 (which is rolled forward to the plan's fiscal year-end of June 30, 20X7), and actuarial valuations are performed on an annual basis, the focus of the procedures would ordinarily be over the over the incremental census data reported to the plan during the year ended June 30, 20X6. Additionally, the procedures should cover the entire year and not be limited to a specific point in time during the year.

If the plan performs biennial valuations, the census data to be tested for the 20X7 valuation would be that reported to the plan since the last valuation (for example, 24-months ending July 1, 20X7).

In this example, the substantive procedures over census data would directly correlate with the actuarial valuation used to measure the OPEB liability as of the plan's year-end. However, the census data tested would not correlate directly with the period for contributions and benefit payments recognized in the current year (that is, the year ended June 30, 20X7). Assuming the auditor believes there is no significant risk of material misstatement due to incomplete or inaccurate census data, the auditor would not ordinarily be expected to test census data reported to the plan during the year ended June 30, 20X7, to support the relevant financial statement assertions related to contributions and benefit payments. Rather, the auditor likely could obtain sufficient audit evidence through analytical procedures.

14.99 The following section provides examples of substantive procedures for auditing the completeness and accuracy of census data related to single-employer OPEB plans when the plan and employer have (are under) the same governance structure as discussed in paragraph 14.16. These procedures are designed to provide audit evidence to support the relevant assertions that are affected by census data, including those related to contributions, contributions receivable, benefit payments, and total OPEB liability.

14.100 The following are examples of substantive procedures when auditing census data used in the measure of total OPEB liability for single employers:

a. Reviewing the actuarial certification (in the actuarial valuation report) to determine whether there were any exceptions identified related to the census data and testing resolution as necessary

b. Obtaining the census data file sent to the actuary from either the actuary or the plan (if obtained from the plan, obtaining evidence that information obtained from the plan was the same information reported to and used by the actuary—for example, obtaining a written confirmation from the actuary)

c. Confirming with the actuary whether there was any missing information or changes made to the census data file provided by plan management

d. Evaluating the potential impact of assumptions used by the actuary in changing census data (for example, corrections to address missing data) on the total OPEB liability

e. Obtaining and testing a reconciliation of aggregate census data to the actuarial valuation report (for example, the total number of members reported in the census data file to amounts shown in the actuarial valuation report)

f. Obtaining and testing a roll forward of the census data from the prior valuation to the current valuation, including testing significant reconciling items

g. Comparing the number of plan members for the current year versus the prior year, as well as the number of plan members versus the number of employees (Consider disaggregating the analysis in various ways—for example, by age of employee and status [active employees, inactive employees entitled to but not yet receiving benefits, or inactive employees or their beneficiaries receiving benefits].)

h. Obtaining a list of new employees hired during the period from the prior valuation to the current valuation from the employer and performing the following procedures:

   i. Selecting a sample to determine that eligible new employees were appropriately enrolled in the plan and properly included in the census data file

   ii. For each employee selected, verifying the accuracy of significant elements of census data from enrollment that are in the census data file to the human resources (personnel) records (for example, name, Social Security number, date of birth, gender, date of hire, marital status, and position or job code)

i. Identifying the payroll registers and payroll cycles for all reporting units of the government *j.* Selecting a sample of active members and performing the following procedures:

> ***Emphasis Point***
>
> Consider selecting a sample of active members from the employer's payroll registers throughout the year and a sample from the census data file.

i. Evaluating whether the employee is eligible to participate in the plan based on the eligibility criteria included in the substantive plan

ii. Comparing the static census data (for example, name, date of birth, date of hire, gender, and spouse's date of birth) in the current census data file to the prior census data file

iii. For significant elements of census data that change based on current-year events and activity (for example, service credits and marital status), verifying the incremental changes to the payroll and personnel records and recalculating the census data in the current census data file based on the prior census data file and the incremental changes for the period

k. Selecting a sample of inactive members entitled to but not yet receiving benefits and comparing the census data information from the current census data file to the prior census data file (or vice versa)

> ***Emphasis Point***
>
> Consider selecting a sample of inactive members entitled to but not yet receiving benefits from the current census data file and a sample from the prior census data file.

l. Selecting a sample of inactive members currently receiving benefits and performing the following procedures:

> ***Emphasis Point***
>
> Consider selecting a sample of inactive members currently receiving benefits from the current census data file and a sample from the prior census data file.

i. Comparing the static census data information from the current census data file to the prior census data file

ii. Verifying or recalculating the significant elements of census data that change, if any, based on criteria in the plan document

Example Audit Procedures to Consider for Agent Plans

14.101 As discussed in paragraph 14.68, financial statements of agent OPEB plans do not reflect any liabilities, deferred outflows of resources, deferred inflows of resources, or expenses that are based on actuarial information. Accordingly, the auditors of agent OPEB plans generally do not need to test census data at participating employers.

14.102 The focus of the procedures performed is on the accumulation and maintenance of census data by the plan based on its role as the record keeper. Accordingly, the auditor generally performs procedures similar to those performed at the plan level for cost-sharing OPEB plans in procedures previously mentioned in paragraph 14.100. The audit procedures should be designed to provide audit evidence to support relevant assertions related to benefit payments. These procedures are designed to provide audit evidence to support benefit payments affected by census data.

Part II—Employer Accounting, Financial Reporting, and Auditing Considerations for Defined Benefit OPEB Plans Administered Through a Qualifying Trust: Single and Agent Employers

Emphasis Point

Part II of this chapter addresses specific accounting and auditing considerations for employers participating in single-employer and agent multiple-employer defined benefit OPEB plans in accordance with GASB Statement No. 75 when the OPEB plan is administered through a qualifying trust. If an OPEB plan is not administered through a qualifying trust, auditors of participating employers should follow the guidance in part IV.

Accounting and Financial Reporting Considerations

Recognition and Measurement in Financial Statements Prepared Using Economic Resources Measurement Focus and Accrual Basis of Accounting (No Special Funding Situation)

14.103 Governments (employers) that provide defined benefit OPEB through a single-employer plan or agent multiple-employer (agent) plan that is administered through a qualifying trust are required to recognize net OPEB liability, OPEB expense, and certain deferred outflows of resources and deferred inflows of resources (OPEB amounts) in their financial statements in accordance with GASB Statement No. 75.

Net OPEB Liability

14.104 Paragraph 27 of GASB Statement No. 75 requires that the net OPEB liability[13] be measured as the portion of the actuarial present value of

[13] In this guide, references to *net OPEB liability* also apply to the situation in which the OPEB plan's fiduciary net position exceeds the total OPEB liability, resulting in a net OPEB asset. For benefits provided through a single-employer or agent plan in which there is a special funding situation, the net OPEB liability, measured in conformity with paragraph 27 of GASB Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*, is referred to as the *collective net OPEB liability*.

projected benefit payments that is attributed to past periods of employee service (total OPEB liability), net of the OPEB plan's fiduciary net position. However, if an employer has fewer than 100 participants (active and inactive) as of the beginning of the OPEB plan's fiscal year, the total OPEB liability *may* be measured using the alternative measurement method discussed in paragraphs 225–226 of GASB Statement No. 75. The assumptions used in measuring the total OPEB liability should be the same as those used for the plan as discussed in part I of this chapter. The fiduciary net position component of net OPEB liability should be determined using the same valuation methods that are used by the OPEB plan for purposes of preparing its statement of fiduciary net position. The net OPEB liability should be measured as of a date (measurement date) no earlier than the end of the employer's prior fiscal year, consistently applied from period-to-period.

> ***Emphasis Point***
>
> Based on the need for information from the OPEB plan, the employer will likely select a measurement date that coincides with the fiscal year-end of the plan.

14.105 When the underlying actuarial valuation is as of a date prior to the required measurement date, paragraph 28 of GASB Statement No. 75 requires the use of update procedures to roll forward the valuation to the measurement date for the employer's reporting. The employer may roll forward an actuarial valuation performed as of a date no more than 30 months and 1 day earlier than the employer's most recent fiscal year-end to the employer's measurement date. Professional judgment should be used to determine the specific update procedures to be used. If significant changes occur between the actuarial valuation date and the measurement date, consideration should be given to whether a new actuarial valuation is needed.

> ***Emphasis Point***
>
> Employers should work collaboratively with the plan to determine the timing and frequency of actuarial valuations, especially if the plan chooses to perform actuarial valuations on a biennial basis. GASB Statement No. 75 requires the total OPEB liability for employers be determined by an actuarial valuation performed as of a date no more than 30 months and 1 day from the employer's most recent fiscal year-end. It is possible for a plan to be in compliance with the requirements of GASB Statement No. 74 (for example, actuarial valuation within 24 months of the plan's fiscal year-end), but the date of that valuation could be greater than 30 months and 1 day from the employer's most recent fiscal year-end, which would not be in compliance with the requirements of GASB Statement No. 75.

OPEB Expense, Deferred Outflows of Resources, and Deferred Inflows of Resources

14.106 The OPEB expense, deferred outflows of resources, and deferred inflows of resources related to OPEB that are required to be recognized by an employer primarily result from changes in the components of the net OPEB liability during the measurement period—that is, changes in the total OPEB liability and the OPEB plan's fiduciary net position. Most changes in the net OPEB liability during the measurement period are included in OPEB expense. For example, changes in the total OPEB liability during the measurement period resulting from current-period service cost, interest on the total OPEB liability, and changes of benefit terms are required to be recognized as OPEB expense in the current reporting period. Projected earnings on the OPEB plan's investments also are required to be included in the determination of OPEB expense in the current reporting period. Exhibit 14-4 of this chapter provides a summary of the various components of OPEB expense.

14.107 Specifically, paragraph 43 of GASB Statement No. 75 states that changes in the net OPEB liability should be recognized in OPEB expense in the current reporting period except as indicated in the following:

a. If the alternative measurement method is not used to measure the total OPEB liability, each of the following should be recognized in OPEB expense, beginning in the current reporting period, using a systematic and rational method over a closed period equal to the average of the expected remaining service lives of all employees that are provided with OPEB through the OPEB plan (active employees and inactive employees) determined as of the beginning of the measurement period:

   i. Differences between expected and actual experience with regard to economic or demographic factors (differences between expected and actual experience) in the measurement of the total OPEB liability

   ii. Changes of assumptions about future economic or demographic factors or of other inputs (changes of assumptions or other inputs)

   The portion of (i) and (ii) not recognized in OPEB expense should be reported as deferred outflows of resources or deferred inflows of resources related to OPEB.

b. The difference between projected and actual earnings on OPEB plan investments should be recognized in OPEB expense using a systematic and rational method over a closed five-year period, beginning in the current reporting period. The amount not recognized in OPEB expense should be reported as deferred outflows of resources or deferred inflows of resources related to OPEB. Deferred outflows of resources and deferred inflows of resources arising from differences between projected and actual OPEB plan investment earnings in different measurement periods should be aggregated and reported as a net deferred outflow of resources related to OPEB or a net deferred inflow of resources related to OPEB.

c. Contributions to the OPEB plan from the employer should not be recognized in OPEB expense.

d. Contributions to the OPEB plan from nonemployer contributing entities that are not in a special funding situation should be recognized as revenue by the employer government.

14.108 Paragraph 44 of GASB Statement No. 75 requires contributions to the OPEB plan from the employer subsequent to the measurement date of the net OPEB liability and before the end of the reporting period (excluding amounts associated with the employer from nonemployer contributing entities that are not in a special funding situation) be reported as deferred outflows of resources related to OPEB.

Exhibit 14-4: Components of OPEB Expense

Components of OPEB Expense	***Impact on OPEB Expense***
Service cost (before effect of employee contributions)	Increase
Employee contributions	Decrease
Interest on total OPEB liability	Increase
Changes in benefit terms	Increase or Decrease
Plan administrative costs	Increase
Projected earnings on plan investments	Decrease
Recognition (amortization) of deferred outflows of resources:	
Differences between expected and actual experience	Increase
Changes of assumptions	Increase
Net difference between projected and actual investment earnings[1]	Increase
Changes in proportion[2]	Increase
Differences between actual contributions and proportionate share[2]	Increase
Recognition (amortization) of deferred inflows of resources:	
Differences between expected and actual experience	Decrease
Changes of assumptions	Decrease
Net difference between projected and actual investment earnings[1]	Decrease
Changes in proportion[2]	Decrease
Differences between actual contributions and proportionate share[2]	Decrease

[1] Note that the net difference between projected and actual investment earnings is presented as either a deferred outflow of resources or a deferred inflow of resources at a single point in time.
[2] Deferred outflows of resources and deferred inflows of resources related to changes in proportion and differences between actual contributions and proportionate share of total employer contributions may be applicable to single and agent employers when allocating OPEB amounts to funds, departments, or component units.

Allocation of OPEB Amounts to Funds or Departments, or Both

14.109 GASB Statement No. 75 does not establish specific requirements for allocation of the net OPEB liability or other OPEB-related amounts to individual funds or departments. However, GASB *Implementation Guide* (IG) 2015-1, question 5.161.2, which addresses the allocation of net pension liability under GASB Statement No. 68, *Accounting and Financial Reporting for Pensions—an Amendment of GASB Statement No. 27*, states as follows:

> For proprietary and fiduciary funds, consideration should be given to National Council on Governmental Accounting (NCGA) Statement 1, *Governmental Accounting and Financial Reporting Principles*, paragraph 42, as amended, which requires that long-term liabilities that are "directly related to, and expected to be paid from" those funds be reported in the statement of net position or statement of fiduciary net position, respectively.

The guidance in GASB IG 2015-1 question 5.129.1 is also relevant for employers participating in defined benefit OPEB plans. Accordingly, when governments allocate OPEB amounts to funds or departments, or both, the allocation methodology described for employers participating in cost-sharing OPEB plans as discussed in part III would be appropriate for such purpose. Such an allocation approach may result in the recognition of additional deferred outflows of resources or deferred inflows of resources related to changes in proportion from year-to-year.

Recognition and Measurement in Financial Statements Prepared Using Current Financial Resources Measurement Focus and Modified Accrual Basis of Accounting

14.110 In financial statements prepared using the current financial resources measurement focus and modified accrual basis of accounting, paragraph 46 of GASB Statement No. 75 specifies that a net OPEB liability should be recognized to the extent the liability is normally expected to be liquidated with expendable available financial resources. OPEB expenditures should be recognized equal to the total of (*a*) amounts paid by the employer to the OPEB plan, including amounts paid for OPEB as the benefits become due, and (*b*) the change between the beginning and ending balances of amounts normally expected to be liquidated with expendable available financial resources. Net OPEB liabilities are normally expected to be liquidated with expendable available financial resources to the extent that benefit payments have matured—that is, benefit payments are due and payable and the OPEB plan's fiduciary net position is not sufficient for payment of those benefits.

Note Disclosures and Required Supplementary Information

14.111 Paragraphs 47–56 of GASB Statement No. 75 address the note disclosures in the financial statements of single and agent employers. The following are among the required disclosures:

- Plan description
- Changes in net OPEB liability (including beginning balances of the components of net OPEB liability, effects during the reporting period of items that change the components of net OPEB liability, and ending balances of the components of net OPEB liability)

- Significant assumptions used to measure the total OPEB liability, including inflation, healthcare cost trend rates, salary changes (if applicable), ad hoc postemployment benefit changes (including ad hoc COLAs), sharing of benefit-related costs with inactive plan members, discount rate, and mortality
- Measurement date of the net OPEB liability and the date of the actuarial valuation or alternative measurement method calculation on which the total OPEB liability is based
- Information about the plan's fiduciary net position

> ***Emphasis Point***
>
> Paragraph 54 of GASB Statement No. 75 requires note disclosures, including information about the plan's assets, deferred outflows of resources, liabilities, deferred inflows of resources, and fiduciary net position (that is, condensed financial information of the plan). However, if (*a*) a financial report that includes disclosure about the elements of the OPEB plan's basic financial statements is available on the Internet, either as a stand-alone financial report or included as a fiduciary fund in the financial report of another government, and (*b*) information is provided about how to obtain the report, reference may instead be made to the other report for these disclosures. In this circumstance, other specific disclosures apply as discussed in paragraph 54.

- Amount of OPEB expense recognized by the employer in the reporting period
- Employer's balances of deferred outflows of resources and deferred inflows of resources related to OPEB by type

14.112 In addition, single and agent employers have to present certain 10-year schedules of RSI[14] and related notes as discussed in paragraphs 57–58 of GASB Statement No. 75, including information on the changes in the employer's net OPEB liability, key ratios, and information on contributions.

Special Funding Situations

14.113 For OPEB plans that are administered through a qualifying trust, GASB Statement No. 75 defines *special funding situations* as circumstances in which a nonemployer entity is legally responsible for making contributions directly to the OPEB plan (including making benefit payments as the OPEB comes due for benefits provided through such a plan) that is used to provide OPEB to the employees of another entity or entities and either of the following criteria is met: (*a*) the amount of contributions for which the nonemployer entity is legally responsible is not dependent upon one or more events unrelated to OPEB, or (*b*) the nonemployer is the only entity with a legal obligation to make contributions directly to an OPEB plan.

14.114 An employer that has a special funding situation for defined benefit OPEB is required to recognize an OPEB liability and deferred outflows of resources and deferred inflows of resources related to OPEB with adjustments for the involvement of nonemployer contributing entities. The employer is required to recognize its proportionate share of the collective OPEB expense, as well as

[14] See footnote 6.

additional OPEB expense and revenue related to the expense recognized by the nonemployer contributing entities. The employer is also required to disclose in the notes to the financial statements information about the amount of support provided by nonemployer contributing entities and present similar information about the involvement of those entities in 10-year schedules of RSI. See paragraphs 99–115 of GASB Statement No. 75 for specific accounting and disclosure requirements related to special funding situations for single and agent employers.

14.115 The recognition and measurement of liabilities, deferred outflows of resources, deferred inflows of resources, and expense by a governmental nonemployer contributing entity in a special funding situation for defined benefit OPEB is similar to that of cost-sharing employers. See paragraphs 116–137 of GASB Statement No. 75 for specific accounting and disclosure requirements related to special funding situations for nonemployer contributing entities.

Auditing Considerations for Single and Agent Employers Administered Through a Qualifying Trust

14.116 This section discusses considerations, including describing the relevant assertions, when auditing the OPEB information included in the employer's financial statements. This section does not include all risks or all procedures that could apply to such audits in accordance with generally accepted auditing standards; instead, it focuses on specific considerations for testing certain financial statement elements of the employer's financial statements affected by defined benefit OPEB plans, including net OPEB liability, deferred outflows of resources, deferred inflows of resources, and OPEB expense. The example substantive audit procedures are not considered required procedures, nor are they all-inclusive.

Determining Audit Strategy

14.117 It is important to note that regardless of the type of OPEB plan, the plan is not considered a component of the employer for purposes of AU-C section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, similar to defined benefit pension plans as discussed in Interpretation No. 1, "Auditor of Participating Employer in a Governmental Pension Plan" (AICPA, *Professional Standards*, AU-C sec. 9600 par. .01–.02), of AU-C section 600. Although this interpretation is specific to pension plans, the concepts covered in the interpretation also apply to OPEB plans. Therefore, the employer auditor is solely responsible for determining the sufficiency and appropriateness of audit evidence necessary to reduce audit risk to an appropriately low level for the OPEB amounts in the audit of the employer's financial statements. That is, the audited financial statements of the plan will not, by themselves, provide the employer auditor sufficient appropriate audit evidence to support the components of net OPEB liability (that is, total OPEB liability and plan fiduciary net position). Absent additional evidence obtained, the employer auditor would not likely be able to accumulate sufficient appropriate audit evidence to support the OPEB amounts and disclosures in the employer's financial statements.

14.118 Determining the audit strategy for the OPEB information in the employer financial statements requires the auditor to understand the type of plan (that is, single-employer, agent, or cost-sharing, as discussed in paragraph

14.08) and what activities the various parties (for example, plan or employer) perform. Example activities include investing and holding plan assets, maintaining records, determining OPEB liabilities, receiving contributions, disbursing benefits (premiums and claims payments), and paying expenses. In determining what activities are performed by the various parties, it is important for the auditor to understand the governance structure of both the plan and the employer.

14.119 Single-employer plans are often administered by the employer's personnel. Conversely, agent plans are almost always administered under a separate governance structure from the employer. The governance structure will affect what information is available to the employer and from whom it may be obtained. Employer management and the auditor will often need information from the plan in addition to the information maintained by the employer. The governance structure may also affect whether there are different auditors for the plan and the employer.

14.120 Understanding the provisions and key elements of the substantive plan (for example, eligibility, contributions, vesting, and benefit payments) is necessary for the auditor to design an appropriate audit strategy. See the emphasis point after paragraph 14.49 that discusses how to determine what constitutes the provisions of the substantive plan.

14.121 The auditor uses the understanding of the type of plan and the party responsible for each activity to understand what can go wrong to identify and assess the risks of material misstatement surrounding those activities in order to determine the nature, timing, and extent of audit procedures. (See chapter 4 of this guide for a discussion of the auditor's risk assessment and response to assessed risks.)

14.122 When activities are performed by the employer in a single-employer plan, controls responsive to the risks tested at the employer may help to reduce the extent of substantive procedures if those controls are operating effectively. Often, controls in effect at the employer specific to agent plans are limited, thus, there may be no benefit to testing operating effectiveness and a substantive approach may be appropriate.

Considerations Specific to Audits of Single Employers

14.123 The audit strategy for single employers may be affected by relationships between the plan, the employer, and their auditors. The audit strategy may also be affected by the governance structure of the plan. Even though administered through a qualifying trust, single employer OPEB plans are most commonly administered under the same governance structure as the employer. In these circumstances, the plan is usually administered by the employer (or its employees), thus there is not a substantive distinction between the plan and the employer. Additionally, when a plan is administered through a qualifying trust under the same governance structure as the employer, often the trust is used solely to accumulate employer contributions for investment purposes (as discussed in the emphasis point after paragraph 14.26). In these circumstances, assets in the trust are not used to pay benefits. Rather, the employer makes benefit payments to inactive plan members from its own resources without reimbursement. The following paragraphs provide different circumstances relevant to single employers. Careful consideration by the employer auditor of the relevant circumstances assists the auditor in designing appropriate audit procedures to obtain evidence on employer OPEB amounts and census data.

14.124 If the plan is not otherwise audited or if the employer auditor has been engaged to audit the plan, the employer auditor is responsible for performing all the substantive audit procedures on the OPEB amounts. When auditing both the plan and the employer, the auditor may design the audits so as to obtain sufficient appropriate audit evidence to support the opinions on both the plan financial statements and the employer financial statements. In this circumstance, the auditor should evaluate the appropriate performance materiality (see chapter 4 of this guide for a further discussion of performance materiality) for purposes of performing the plan and employer audits. In many circumstances, procedures performed to obtain sufficient appropriate audit evidence on the OPEB amounts for the employer will be performed using a lower performance materiality than that needed for the audit of the plan financial statements. Accordingly, when the auditor is performing procedures to obtain evidence for both the plan and the employer financial statements, the procedures should be performed using the lowest materiality of the applicable opinion units.

14.125 In circumstances in which the plan is audited by another auditor, the employer auditor evaluates the degree of evidence the audited financial statements of the plan may provide. In performing this evaluation, the auditor considers the reporting unit (and related opinion unit) that the plan auditor is opining on to better understand the likely performance materiality used for the audit of the plan. For example, although the financial statements for a PERS include a combining financial statement for all plans administered, those financial statements represent a single opinion unit. Therefore, the auditor of the PERS generally plans and performs the plan audit based on a performance materiality established for the opinion unit as a whole and not for each separate plan (assuming the plan auditor was not engaged to report at a lower level than the single opinion unit). In this circumstance, the audited PERS financial statements would likely provide little, if any, audit evidence for the employer auditor. In contrast, if the plan auditor is engaged to issue a separate opinion on the individual OPEB plan financial statements, this may provide some audit evidence for the employer auditor. However, even in this circumstance, the employer auditor would require additional audit evidence on the OPEB amounts, including the completeness and accuracy of census data maintained by the plan. A method for obtaining evidence related to such census data is for employer management to request that plan management engage its auditor to perform an examination engagement in accordance with AT-C section 205 over census data controlled by the plan as discussed in paragraph 14.135.

14.126 A potentially more efficient method for the employer auditor to obtain evidence on the employer OPEB amounts when another auditor audits the plan is for employer management to request that plan management engage its auditor to obtain reasonable assurance and report on net OPEB liability, total deferred outflows of resources, total deferred inflows of resources, and OPEB expense of the employer (similar to the proposed solutions described in appendix B, "Governmental Employer Participation in Cost-Sharing Multiple-Employer Plans: Issues Related to Information for Employer Reporting," of chapter 13 for employers participating in cost-sharing multiple-employer defined benefit pension plans, adapted as appropriate for OPEB plans). This approach would likely involve minimal additional audit effort by the plan auditor (in comparison to the plan auditor being engaged to issue a separate opinion on the individual plan financial statements) while reducing the audit procedures performed by the employer auditor. This would also likely alleviate the need for the employer auditor to obtain additional audit evidence on the census data maintained by the plan; thus, an examination engagement over census data discussed in paragraph 14.125 would not be necessary.

Considerations Specific to Audits of Agent Employers

14.127 Each agent employer will be challenged about how to obtain all information to support the specific OPEB amounts presented in its financial statements, including net OPEB liability, deferred outflows of resources, deferred inflows of resources, and OPEB expense. Specific OPEB amounts are dependent on certain accounting records maintained by the plan, the controls and processes of the plan, as well as the calculations by the plan's actuary. The employer is solely responsible for its financial statements and, therefore, it is employer management's responsibility to establish financial reporting processes and controls over the recognition, measurement, presentation, and disclosure of its various OPEB amounts.

14.128 Similarly, employer auditors will be challenged in terms of obtaining sufficient appropriate evidence regarding the specific OPEB amounts included in employer financial statements. AU-C section 500 states that the objective of the auditor is to design and perform audit procedures that enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.

14.129 Appendix A of chapter 13 provides a two-part approach to address the challenges of employers and their auditors for defined benefit pension plans (including the census data considerations discussed in paragraphs 14.130–.135), which may be adapted as appropriate for agent OPEB plans. Although this guidance is specific to pension plans, the concepts also apply to OPEB plans. The first part may be used to address total OPEB liability, deferred outflows of resources, deferred inflows of resources, and OPEB expense, and the second part may be used to address the employer's specific interest in the agent OPEB plan's fiduciary net position. The substantive audit procedures included in this chapter for audits of agent employers assume that the agent OPEB plans provide employers with the recommended information and related audit reports discussed in appendix A of chapter 13, adapted as appropriate for OPEB plans.

Emphasis Point

In accordance with Interpretation No. 3, "Auditor of Participating Employer in a Governmental Agent Multiple-Employer Pension Plan" (AICPA, *Professional Standards*, AU-C sec. 9500 par. .30–.36), of AU-C section 500 , it is important for employer auditors to understand that obtaining the audited plan financial statements and additional unaudited information provided by the plan's management to calculate the employer's net pension liability will not provide sufficient appropriate audit evidence to support the relevant assertions in the employer's financial statements. Although this interpretation is specific to pension plans, the concepts covered in the interpretation also apply to OPEB plans.

Census Data

14.130 As discussed in paragraphs 14.14–.16, certain financial statement elements of single and agent employers that participate in defined benefit OPEB plans (that is, net OPEB liability, deferred outflows of resources, deferred inflows of resources, and OPEB expense) are dependent on members' demographic data (census data). The employer auditor's consideration of the relevant financial statement assertions that are dependent on census data begins with understanding the processes and internal control used by the employer and the plan to support the completeness and accuracy of significant elements of census data that are provided to the actuary.

14.131 *Significant elements of census data* include those elements that, either individually or when combined with other elements, could result in a material misstatement to one or more elements of the employer's financial statements (that is, net OPEB liability, deferred outflows of resources, deferred inflows of resources, and OPEB expense). Significant elements of census data may include some or all of the following:

- *a.* Name
- *b.* Social Security number
- *c.* Date of birth
- *d.* Date of hire
- *e.* Marital status
- *f.* Dependents
- *g.* Service credits (periods of time worked)
- *h.* Class of employee
- *i.* Position or job code (or both)
- *j.* Gender
- *k.* Date of termination or retirement
- *l.* Spouse's date of birth
- *m.* Employment status (active, inactive entitled to but not receiving benefits, retired)

The significance of some of these elements, all of these elements, or additional elements to any plan will be based on the impact that a particular census data element has on the measurement of a particular financial statement element.

> ***Emphasis Point***
>
> Many OPEB plans allow members to choose from more than one health care plan option through an annual open enrollment process (for example, an HMO, PPO, or traditional indemnity plan). Although the benefits election is not an element of census data, such elections are considered in the utilization assumptions by the actuary in projecting benefit (claims) costs in the actuarial valuation.

14.132 The substantive procedures over census data at the employer are ordinarily based on a concept that focuses on testing incremental changes to the census data file since the prior actuarial valuation, assuming (*a*) the prior year financial statements were audited, (*b*) there were no modifications to the auditor's report in the prior year related to census data, and (*c*) the auditor has concluded there is no significant risk of material misstatement due to incomplete or inaccurate census data from prior years. These procedures would ordinarily cover the census data changes during 1) the year immediately preceding the actuarial valuation when the actuarial valuation is performed on an annual basis, or 2) the two-year period immediately preceding the actuarial valuation when the actuarial valuation is performed on a biennial basis.

14.133 When the governance structure of the plan and employer are the same, the underlying records are typically maintained by the same party. This is usually the case for most single-employer plans. In this circumstance, the employer would likely have access to the underlying records of both the active and inactive members and test the underlying data of selected members each year to obtain sufficient appropriate evidence that the significant elements of census data reported to the actuary are complete and accurate.

14.134 When the plan and employer are under different governance structures, as discussed in paragraph 14.15, the underlying records that support the census data are maintained by different parties. This is almost always the case for agent plans and sometimes the case for single-employer plans. When different governance structures exist, the underlying records of active members are typically maintained by the employers. The underlying records of plan members who are no longer employed by the government (that is, inactive members) are typically maintained by the plan. The underlying records of active members maintained by the employer for purposes of testing the *significant elements of census data* that were reported to the plan during the period could be tested by the employer auditor, but access to information for the census data maintained by the plan necessitates additional support from the plan and the plan's auditor.

14.135 To address this and other challenges of agent employers and their auditors, appendix A of chapter 13 for defined benefit pension plans includes two options for the agent employer auditor to obtain evidence from the plan related to census data, which may be adapted as appropriate for agent OPEB plans. The first option is for the plan to engage an auditor to issue a type 2 SOC 1 report on controls over census data maintained by the plan. The second option is for the plan to engage an auditor to perform an examination engagement in accordance with AT-C section 205 on plan management's assertion relating to the completeness and accuracy of census data maintained by the plan. Additional responsibilities of the employer auditor related to census data are discussed in paragraph 14.143.

Special Funding Situations

14.136 Some single-employer and agent plans include *special funding situations*, as discussed in paragraph 14.113. The audit guidance in this chapter does not address special funding situations. If such a situation exists, the employer auditor should perform appropriate audit procedures.

14.137 As GASB Statement No. 75 provides specific criteria to be considered a special funding situation, careful evaluation of the employer's documentation to substantiate whether there is, or is not, a special funding situation is necessary. Such documentation may need to include a legal opinion if the relevant statutes or substantive plan document are not specifically based on the criteria in GASB Statement No. 75. For financial reporting purposes, such legal opinion should be based on the criteria for a special funding situation in GASB Statement No. 75, as opposed to a legal notion of liability or obligation.

Net OPEB Liability, Deferred Outflows of Resources, Deferred Inflows of Resources, and OPEB Expense for Single and Agent Employers

14.138 In addition to the discussion in chapter 4 of this guide related to the auditor's risk assessment and understanding of the entity, auditor considerations specific to total OPEB liability, net OPEB liability, deferred outflows of resources, deferred inflows of resources, and OPEB expense include obtaining an understanding of the actuary's objectives, scope of work, methods and assumptions, and consistency of application.

Relevant Assertions

14.139 The relevant assertions related to net OPEB liability, deferred outflows of resources, deferred inflows of resources, and OPEB expense for single and agent employers include the following:

- *a.* Member census data used in calculating the actuarially computed total OPEB liability is complete and accurate.
- *b.* Actuarial assumptions used in computing the total OPEB liability are in accordance with GASB Statement No. 75 requirements and the Actuarial Standards of Practice.
- *c.* The employer OPEB amounts, including net OPEB liability, deferred outflows of resources, deferred inflows of resources, and OPEB expense have been properly calculated and reported in the financial statements in accordance with GASB Statement No. 75 and in the proper period and are properly disclosed.

Examples of Identified Risks of What Can Go Wrong at the Relevant Assertion Level

14.140 The following are examples of identified risks of what can go wrong at the relevant assertion level related to net OPEB liability, deferred outflows of resources, deferred inflows of resources, and OPEB expense for single and agent employers.

Net OPEB Liability

- *a.* The actuary does not have the appropriate qualifications or related experience to perform the valuation.
- *b.* Members are inappropriately excluded from, or included in, the census data.
- *c.* Census data does not reconcile to (agree with) the employer's payroll and personnel records, causing errors in the computation of total OPEB liability.
- *d.* The plan does not properly accumulate (maintain) the census data based on information reported by the employer for active members as well as activity for census data controlled by the plan for inactive members, causing errors in the computation of total OPEB liability.
- *e.* The actuary uses incomplete (missing) or incorrect census data, causing errors in the computation of total OPEB liability.
- *f.* The actuary uses inappropriate assumptions or actuarial methods that are not in conformity with GASB Statement No. 75 and the Actuarial Standards of Practice, causing errors in the computation

of total OPEB liability. Examples of inappropriate assumptions or actuarial methods include the following:

i. Using an actuarial cost method other than entry age normal for computing the total OPEB liability

ii. Using a long-term rate of return that does not reflect the future expected rate of return on plan investments based on investment strategy and target asset allocations

iii. Using a health care trend rate that does not reflect the future expected increases in per capita health claim rates over time due to factors such as medical inflation, utilization, plan design, and technology improvements

iv. Using a cost change rate that does not reflect the future expected increases of other costs such as the cost of life insurance and long-term care insurance

v. Not properly considering current and future participation rates of members in projection of benefits

> ***Emphasis Point***
>
> For plans that require some form of contribution to maintain coverage, some eligible individuals may elect not to be covered, particularly if they have other coverage available. In accordance with Actuarial Standard of Practice No. 6, empirical data on plan participation, where available and credible, should be considered when selecting the participation assumption for future retirees. When developing the participation rates, the actuary should consider how plan eligibility rules, plan choices, or retiree contribution rates have changed over time.
>
> Furthermore, plan participation may be different in the future due to participants' response to changes in retiree contribution levels and plan choices (for example, Medicare+Choice). For plans that anticipate changes in retiree contributions, the actuary should consider the appropriateness of participation rates that vary over the projection period for both current and future retirees. The actuary should consider plan eligibility rules governing dropping coverage and subsequent reenrollment when selecting participation rates.

vi. Using inappropriate cash flow projections when calculating the discount rate

vii. Using mortality assumptions that do not properly reflect expected future improvement in mortality rates

g. Projected benefit payments used in the actuarial valuation do not include all benefits to be provided to plan members in accordance with the benefit terms that are in force at the measurement date, causing the inaccurate computation of the total OPEB liability.

h. Projected benefit payments used in the actuarial valuation do not include the effects of automatic postemployment benefit changes, ad hoc benefit changes that are substantively automatic, or projected salary changes, causing the inaccurate computation of the total OPEB liability.

i. Projected benefit payments used in the actuarial valuation do not include taxes or other assessments expected to be imposed on benefit payments, causing the incorrect computation of the total OPEB liability.

j. Projected benefit payments are not based on claims costs, or age-adjusted premiums approximating claims costs, causing the incorrect computation of the total OPEB liability.

k. Plan amendments or changes in benefit terms have not been properly included or excluded as of the measurement date. See the emphasis point on substantive plans after paragraph 14.49.

l. The fiduciary net position used in calculating the net OPEB liability as of the measurement date is not the same as the fiduciary net position reported in the plan's statement of fiduciary net position.

Deferred Outflows of Resources and Deferred Inflows of Resources

m. Deferred outflows of resources and deferred inflows of resources are not properly calculated and reported in accordance with GASB Statement No. 75.

n. Changes in benefit terms have been incorrectly reported as deferred outflows of resources or deferred inflows of resources.

o. The amortization period used to recognize (amortize) deferred outflows of resources and deferred inflows of resources for each respective year's incremental deferrals has not been properly calculated in accordance with GASB Statement No. 75. For example, the plan incorrectly calculates the amortization period for changes in assumptions based on the average remaining service lives of active employees, instead of the average remaining service lives of all employees (that is, active and inactive plan members).

p. Contributions to the plan subsequent to the measurement date are not recognized as a deferred outflow of resources.

OPEB Expense

q. OPEB expense is not properly calculated and reported in accordance with GASB Statement No. 75.

r. Contributions to the plan are directly considered in OPEB expense.

s. OPEB expense does not properly reflect the impact of service cost (addition) and employee contributions (deduction) based on the actuarial valuation used to measure net OPEB liability.

t. OPEB expense does not properly reflect the interest on the total OPEB liability (addition) and projected earnings on plan investments (deduction).

u. OPEB expense does not include the appropriate amount for the recognition (amortization) of deferred outflows of resources and deferred inflows of resources.

v. OPEB expense does not include changes in benefit terms.

Example Audit Procedures to Consider

Total OPEB Liability (Component of Net OPEB Liability)

14.141 The following are examples of substantive procedures for auditing the total OPEB liability component (excluding census data) of net OPEB liability for single and agent employers:

a. Obtaining the actuarial valuation report used to measure the total OPEB liability as of the measurement date based on GASB Statement No. 75

> ***Emphasis Point***
>
> Plans often have different actuarial valuations performed for accounting (for example, accounting pursuant to GASB Statement No. 75) and funding (for example, actuarially determined contribution) purposes. The employer should provide to the employer auditor a complete actuarial valuation report that has been prepared for accounting purposes that includes an actuarial certification.

> ***Emphasis Point for Agent Employers***
>
> Each employer participating in an agent plan requires a separate actuarial valuation based on each employer's specific census data and plan provisions. In order for the agent employer and the employer auditor to consider the actuary as a management specialist[15] for the indicated OPEB amounts, employer management needs to obtain an actuarial valuation report specific to their entity. Appendix A in chapter 13 includes a recommendation that the actuary of the plan issue a separate actuarial valuation report for and addressed to each employer in a defined benefit pension plan. This recommendation is also applicable to employers participating in a defined benefit OPEB plan. Accordingly, this would include total OPEB liability, fiduciary net position, net OPEB liability, deferred outflows of resources and deferred inflows of resources by category and year, OPEB expense, the discount rate calculation (including comparing projections of the OPEB plan's fiduciary net position to projected benefit payments), and other standard actuarial information. Appendix A in chapter 13 also includes a recommendation that the actuarial certification be addressed to employer management, which is also applicable to a defined benefit OPEB plan.

b. Evaluating the professional qualifications of the actuary, including his or her competence, capabilities, and objectivity as required by paragraph .08 of AU-C section 500 (If the actuary is not known to the auditor, consider other factors that might provide information regarding the actuary's qualifications, such as [i] the actuary's membership in a recognized professional organization, [ii] the number and types of OPEB plans served, including years of experience,

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[15] A *management's specialist* is an individual or organization possessing expertise in a field other than accounting or auditing whose work in that field is used by the entity to assist the entity in preparing the financial statements. AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*), addresses the auditor's responsibilities when information to be used as audit evidence has been prepared using the work of a management's specialist.

and [iii] the opinion of other actuaries whom the auditor knows to be qualified regarding the actuary's professional qualifications.)

> ***Emphasis Point***
>
> Paragraph .12 of AU-C section 300 states the auditor should consider whether specialized skills are needed in performing an audit. Consideration of the engagement team's skills, knowledge, and experience as they relate to understanding actuarial information is critical in such engagements. If specialized skills are needed, consider using an auditor specialist (for example, an actuary) in evaluating the appropriateness of the actuarial valuation and the measurement of the total OPEB liability.

c. Inquiring about the nature of any interests or relationships the actuary may have with the plan or employer(s) that may create threats to the actuary's objectivity (for example, financial interests, business or personal relationships, or the provision of other services) and any applicable safeguards

> ***Emphasis Point***
>
> Although safeguards cannot eliminate all threats to the objectivity of an actuary, threats such as intimidation by management may be of less significance to a specialist engaged versus employed by the plan or plan administrator, and the effectiveness of safeguards such as quality control procedures may be greater. This evaluation of objectivity may be accomplished by the auditor asking management to have the actuary describe in writing interests and relationships, if any, that may exist and that may appear to impair the objectivity of the actuary.

d. Reading the actuarial certification for potential exclusions from the scope of the actuary's work or qualifications on the actuary's certification relating to actuarial methods, actuarial assumptions, or census data

e. Inquiring of management or the actuary whether the actuarial valuation considers all pertinent provisions of the plan, including any changes or amendments to the plan or other events affecting the actuarial calculations that are effective as of the measurement date (See the emphasis point after paragraph 14.49 regarding what should be considered in determining the substantive plan.)

> ***Emphasis Point***
>
> Other considerations include whether the valuation includes or does not include the impact of the Medicare subsidy provided by the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 as well as taxes and other assessments.

f. Determining whether the actuarial valuation was performed as of a date no more than 30 months and 1 day from the employer's fiscal year-end *g.* Evaluating whether the methods and assumptions used in determining the total OPEB liability are in accordance with GASB Statement No. 75 and Actuarial Standards of Practice and are the same as those used by the plan (See examples of identified risks of what can go wrong related to actuarial assumptions in paragraph 14.140*f*.)

h. If the actuarial valuation was performed as of a date prior to the measurement date, reviewing the appropriateness of the update procedures to roll forward the total OPEB liability to the measurement date and determining whether all significant known events occurring between the valuation date and the measurement date have been properly included

i. Testing the reliability and completeness of the member census data used (See paragraphs 14.142–.143 for specific procedures.)

j. Evaluating the propriety of the long-term expected rate of return used in the calculation of the discount rate

Emphasis Point

Paragraph 40 of GASB Statement No. 75 requires the long-term expected rate of return used in the calculation of the discount rate to be forward-looking and be based on the appropriate expected long-term rate of return considering target asset allocations. It is often developed using a building-block approach based on portfolio modeling. Employer management should evaluate the appropriateness of the rate each year based on current information. When evaluating the reasonableness of management's assumption regarding the long-term expected rate of return, the auditor is cautioned to avoid evaluating the reasonableness of this assumption solely based on retrospective analysis of historical investment returns or comparison to the rate used by other plans.

k. Evaluating whether the discount rate is reasonable and is a single rate in accordance with GASB Statement No. 75:

i. Obtaining the discount rate calculation and supporting schedules as of the measurement date

ii. Testing the mathematical accuracy of the discount rate calculation and supporting schedules

iii. Performing the following procedures on the components[16] of the projection of the plan fiduciary net position (that is, net position roll forward):

(1) Tracing beginning plan fiduciary net position to audited plan financial statements

(2) Comparing employer (including nonemployer contributing entity, if applicable) and employee contributions in (future) year one to actual contributions in current year audited plan financial statements

[16] Components would include projected beginning fiduciary net position by year, projected contributions for the year, projected benefit payments for the year, projected investment return for the year, projected administrative expenses for the year, and ending fiduciary net position.

(3) Evaluating reasonableness of projected future employer (including nonemployer contributing entity, if applicable) and employee contributions based on age demographics of active plan members (As active plan members retire, projected future contributions will decrease dramatically as employer and employee contributions related to future employees are excluded.)

(4) Evaluating appropriateness of projected future employer (including nonemployer contributing entity, if applicable) contributions based on the criteria in paragraph 38 of GASB Statement No. 75

Emphasis Point

As discussed in paragraphs 38–39 of GASB Statement No. 75, employer management should apply professional judgment to project cash flows for contributions from the employer and nonemployer contributing entities in circumstances in which (*a*) those contribution amounts are established by statute or contract or (*b*) a formal, written policy related to those contributions exists. Employer management's application of professional judgment should consider the most recent five-year contribution history (to determine the degree of adherence to preceding [*a*] and [*b*]) of the employers and nonemployer contributing entities as a key indicator of future contributions from those sources and should reflect all other known events and conditions.

In circumstances in which a statute or formal written policy exists that requires increasing contribution rates in future years, employer management's application of professional judgment will likely be challenging with respect to determining whether to consider such funding in projected cash flows for contributions. Further, in evaluating the appropriateness of the employer management's judgment about future contributions, the auditor considers the most recent five-year history and evaluates the likelihood that the increased contribution will be made. In evaluating the likelihood that increased contributions will be made, the auditor may consider whether the government has a history of amending similar statutes and written policies due to the inability to make the required contributions.

In circumstances other than those described in (*a*) and (*b*), the amount of projected cash flows for contributions from the employer and nonemployer contributing entities should be limited to an average of contributions from those sources over the most recent five-year period (percentage of covered payroll contributed or percentage of actuarially determined contributions made) and may be modified based on consideration of subsequent events.

(5) Comparing (future) year one benefit payments to actual benefit payments in the current year audited plan financial statements

(6) Evaluating reasonableness of projected future benefit payments based on age demographics of current plan members, projected retirement dates, projected benefit payments based on the

applicable benefit formula, and mortality assumptions used in the actuarial valuation

(7) Recalculating investment earnings by year based on the long-term expected rate of return

iv. Performing the following on the calculation of actuarial present values of the projected benefit payments:

(1) Tracing beginning fiduciary net position each year and projected benefit payments to net position roll forward tested previously

(2) For future years in which beginning fiduciary net position is sufficient to pay projected benefits for the respective year, determining whether the projected benefit payments were properly discounted using the long-term expected rate of return on plan investments

(3) For future years in which beginning fiduciary net position is not sufficient to pay projected benefits for the respective year, determining whether the projected benefit payments were properly discounted using an appropriate 20-year AA municipal bond yield or index rate as of the measurement date

(4) Recalculating the single (blended) discount rate

l. Verifying that the fiduciary net position used in calculating the net OPEB liability is the same as the fiduciary net position reported in the plan's statement of fiduciary net position

m. Recomputing the calculation for the *net OPEB liability*, this is the total OPEB liability less the plan fiduciary net position as of the measurement date

Census Data—Single Employers

14.142 The following are examples of substantive procedures when auditing census data used in the measure of total OPEB liability for single employers:

Emphasis Point

As discussed in paragraph 14.132, the substantive procedures over census data are ordinarily based on a concept that focuses on testing incremental changes to the census data file during 1) the year immediately preceding the actuarial valuation date when actuarial valuations are performed on an annual basis, or 2) the two-year period immediately preceding the actuarial valuation when the actuarial valuations are performed on a biennial basis. These procedures would ordinarily cover the incremental census data accumulated by the plan (that is, changes to the census data file) during the applicable period.

For example, if a plan has a fiscal year-end of June 30, 20X7, and uses a beginning of the year actuarial valuation as of July 1, 20X6 (which is rolled forward to the plan's fiscal year-end of June 30, 20X7), and actuarial valuations are performed on an annual basis, the focus of the procedures would ordinarily be over the incremental census data accumulated by the plan during the year ended June 30, 20X6. Additionally, the procedures should cover the entire year and not be limited to a specific point in time during the year.

If the plan performs biennial valuations, the census data to be tested for the July 1, 20X6, valuation would be that reported to the plan since the last valuation (that is, the two-year period ending June 30, 20X6).

In this example, the substantive procedures over census data would directly correlate with the actuarial valuation used to measure the OPEB liability as of the plan's year-end. However, the census data tested would not correlate directly with the period for contributions and benefit payments recognized in the current year (that is, the year ended June 30, 20X7). Assuming the auditor believes there is no significant risk of material misstatement due to incomplete or inaccurate census data, the auditor would not ordinarily be expected to test census data reported to the plan during the year ended June 30, 20X7, to support the relevant financial statement assertions related to contributions and benefit payments. Rather, the auditor likely could obtain sufficient audit evidence through analytical procedures.

a. Reviewing the actuarial certification (in the actuarial valuation report) to determine whether there were any exceptions identified related to the census data and testing resolution as necessary

b. Obtaining the census data file sent to the actuary from either the actuary or the plan (if obtained from the plan, obtaining evidence that information obtained from the plan was the same information reported to and used by the actuary—for example, obtaining a written confirmation from the actuary)

c. Confirming with the actuary whether there was any missing information or changes made to the census data file provided by plan management

d. Evaluating the potential impact of assumptions used by the actuary in changing census data (for example, corrections to address missing data) on the total OPEB liability

e. Obtaining and testing a reconciliation of aggregate census data to the actuarial valuation report (for example, the number of members reported in the census data file to amounts shown in the actuarial valuation report)

f. Obtaining and testing a roll forward of the census data from the prior valuation to the current valuation, including testing significant reconciling items

g. Comparing the number of plan members for the current year versus the prior year, as well as the number of plan members versus the number of employees (Consider disaggregating the analysis in various ways—for example, by age of employee and status [active employees, inactive employees entitled to but not yet receiving benefits, or inactive employees or their beneficiaries receiving benefits].)

h. Obtaining a list of new employees hired during the period from the prior valuation to the current valuation from the employer and performing the following procedures:

i. Selecting a sample to determine that eligible new employees were appropriately enrolled in the plan and properly included in the census data file

ii. For each employee selected, verifying the accuracy of significant elements of census data from enrollment that are in the census data file to the human resources (personnel) records (for example, name, Social Security number, date of birth, gender, date of hire, marital status, and position or job code)

i. Identifying the payroll registers and payroll cycles for all reporting units of the government

j. Selecting a sample of active members and performing the following procedures:

> ***Emphasis Point***
>
> Consider selecting a sample of active members from the employer's payroll registers throughout the year and a sample from the census data file.

i. Evaluating whether the employee is eligible to participate in the plan based on the eligibility criteria included in the plan document (state statutes)

ii. Comparing the static census data (for example, name, date of birth, date of hire, gender, and spouse's date of birth) in the current census data file to the prior census data file

iii. For significant elements of census data that change based on current-year events and activity (for example, service credits and marital status), verifying the incremental changes to the personnel records and recalculating the census data in the current census data file based on the prior census data file and the incremental changes for the period

> ***Emphasis Point***
>
> The following procedures (items *k* and *l*) pertaining to inactive member data may not be necessary when the employer auditor obtains evidence from the plan. See paragraphs 14.124–.125.

k. Selecting a sample of inactive members entitled to but not yet receiving benefits and comparing the census data information from the current census data file to the prior census data file (or vice versa)

> ***Emphasis Point***
>
> Consider selecting a sample of inactive members entitled to but not yet receiving benefits from the current census data file and a sample from the prior census data file.

l. Selecting a sample of inactive members currently receiving benefits and performing the following procedures:

Emphasis Point

Consider selecting a sample of inactive members currently receiving benefits from the current census data file and a sample from the prior census data file.

i. Comparing the static census data information from the current census data file to the prior census data file

ii. Verifying or recalculating the significant elements of census data that change based on criteria in the plan document

Census Data—Agent Employers

14.143 The following are examples of substantive procedures when auditing census data used in the measure of total OPEB liability for agent employers (see the emphasis point preceding paragraph 14.142):

a. Reviewing the actuarial certification (in the actuarial valuation report addressed to the employer) to determine whether there were any exceptions identified related to the census data and testing resolution as necessary

b. Obtaining the census data file sent to the actuary from either the actuary or the plan (if obtained from the plan, obtaining evidence that information obtained from the plan was the same information reported to and used by the actuary—for example, obtaining a written confirmation from the actuary)

c. Confirming with the actuary whether there was any missing information or changes made to the census data file provided by plan management

d. Evaluating the potential impact of assumptions used by the actuary in changing census data (for example, corrections to address missing data) on the total OPEB liability

e. Obtaining and testing a reconciliation of aggregate census data to the actuarial valuation report (for example, the number of members reported in the census data file to amounts shown in the actuarial valuation report)

f. Obtaining and testing a roll forward of the census data from the prior valuation to the current valuation, including testing significant reconciling items

g. Comparing the number of plan members for the current year versus the prior year, as well as the number of plan members versus the number of employees (Consider disaggregating the analysis—for example, by age of employee, status [that is, active employees, inactive employees entitled to but not yet receiving benefits, or inactive employees or their beneficiaries receiving benefits].)

h. Obtaining a list of new employees hired during the period from the prior valuation to the current valuation from the employer and performing the following procedures:

i. Selecting a sample to determine that eligible new employees were appropriately enrolled in the plan and properly included in the employer (payroll) transmission reports and census data file

ii. For each employee selected, verifying the significant elements of census data reported to the plan upon enrollment to the human resources (personnel) records (for example, name, Social Security number, date of birth, gender, date of hire, marital status, and position or job code)

i. Obtaining a list of status changes during the period from the prior valuation to the current valuation (other than those reported through the employer [payroll] transmission reports) and selecting a sample to determine that they were appropriate based on the relevant plan criteria and underlying personnel records

j. Selecting a sample of active members and performing the following procedures:

Emphasis Point

Consider selecting a sample from the employer's payroll registers throughout the year and the employer (payroll) transmission reports throughout the year.

i. Agreeing details included in the employer (payroll) transmission report (for example, name, position or job code, periods of time worked, pensionable wages for the period, employer contribution for the period, and employee contribution for the period) to the payroll register (or vice versa) and agree the underlying information to the payroll and personnel records

ii. Evaluating whether the selected employee is eligible to participate in the plan based on the eligibility criteria included in the plan document (state statutes)

iii. Recalculating service credits

k. Selecting a sample of employees from the employer's payroll system to determine whether they are properly enrolled in the plan and included in the census data file or properly excluded from the plan

Additional Procedures Related to Census Data Maintained by the Plan

l. Obtaining from the plan evidence over the completeness and accuracy of census data maintained by the plan (for example, either [i] a type 2 SOC 1 report on controls over census data maintained by the plan, or [ii] an examination report (opinion) in accordance with AT-C section 205 on plan management's assertion relating to the completeness and accuracy of census data maintained by the plan) (See appendix A in chapter 13, adapted as appropriate for agent OPEB plans.)

m. Evaluating whether the plan auditor's report (type 2 SOC 1 report or examination report in accordance with AT-C section 205) is adequate and appropriate for the employer auditor's purposes

Emphasis Point

Before using the work of the plan auditor as evidence, regardless of whether the type 2 SOC 1 or examination-level reporting options related to the census data maintained by the plan (see appendix A of chapter 13, adapted as appropriate for agent OPEB plans) are used, the employer auditor should evaluate whether the plan auditor's report is adequate and appropriate for the employer auditor's purposes. For purposes of this evaluation, the employer auditor may review the plan auditor's report and any related opinion modifications or exceptions and assess other matters discussed in the report. If a type 2 SOC 1 report is obtained, employer auditors should apply the guidance in AU-C section 402, *Audit Considerations Relating to an Entity Using a Service Organization* (AICPA, *Professional Standards*), to properly utilize the report. Paragraph .13*a* of AU-C section 402 requires when determining the sufficiency and appropriateness of the audit evidence provided by a type 2 SOC 1 report, the employer auditor should be satisfied that the auditor providing the type 2 SOC 1 report is competent and independent from the plan.

Fiduciary Net Position (Component of Net OPEB Liability)—Single Employers

Emphasis Point

The following three paragraphs provide example substantive audit procedures under different circumstances relevant to single employers. Careful consideration by the employer auditor of the relevant circumstances is necessary in order to select which paragraph is most applicable. See paragraphs 14.123–.126.

Paragraph 14.144 provides guidance when the employer auditor is performing substantive audit procedures on certain elements (accounts) of the plan financial statements, regardless of whether the employer auditor has been engaged to issue a separate opinion on the plan financial statements. These procedures assume that another auditor has not been engaged to audit the plan financial statements.

Paragraph 14.145 provides guidance for the employer auditor when another auditor has been engaged to issue an opinion on the financial statements of the (individual) plan. As discussed in paragraph 14.125, the audited PERS financial statements that report more than one plan likely will provide little, if any, audit evidence for the employer auditor unless the plan auditor had been engaged to issue separate opinions on the individual plans' financial statements.

Paragraph 14.146 provides guidance when the plan prepares a schedule of OPEB amounts that includes total OPEB liability, fiduciary net position, and net OPEB liability, for which the plan engages its auditor to obtain reasonable assurance and report on the net OPEB liability in accordance with AU-C section 805, *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement* (AICPA, *Professional Standards*).

14.144 The following are examples of substantive procedures for auditing the fiduciary net position component of net OPEB liability for single employers when the employer auditor is performing all the substantive procedures:

a. Obtaining a detailed schedule of fiduciary net position for the plan as of the measurement date that includes all plan assets, deferred outflows of resources, liabilities, and deferred inflows of resources and performing the following:

   i. Performing substantive procedures on the elements similar to those performed for a single-employer plan as described in part I of this chapter

   ii. Reconciling to fiduciary net position used by the actuary in the calculation of the net OPEB liability

b. Obtaining a detailed schedule of changes in fiduciary net position for the plan that includes all additions and deductions for the measurement period and performing the following:

   i. Agreeing beginning fiduciary net position to the prior year audited financial statements

   ii. Performing substantive procedures on the relevant elements of additions (for example, contributions and investment income) and deductions (for example, benefit payments and administrative expenses) during the measurement period similar to those performed for a single-employer plan as described in part I of this chapter

14.145 The following are examples of substantive procedures for auditing the fiduciary net position component of net OPEB liability for single employers when the employer auditor is obtaining audited plan financial statements (audited by another auditor) and is performing additional procedures on components of changes in fiduciary net position:

a. Obtaining audited plan financial statements

b. Evaluating whether the plan auditor's report is adequate and appropriate for the employer auditor's purposes

c. Agreeing beginning fiduciary net position for the employer to the prior year audited financial statements

d. Verifying the completeness and accuracy of the employer and employee contributions (if applicable) attributed to the employer

e. Performing analytical procedures over benefit payments by developing an expectation based on prior year benefit payments adjusted for changes in employer census data

f. Performing analytical procedures on investment income and administrative expense by developing an expectation based on expected return on average investments and the prior year's administrative expenses adjusted for changes in number of participants

g. Recomputing ending fiduciary net position based on its elements

h. Reconciling to fiduciary net position used by the actuary in the calculation of the net OPEB liability

i. Agreeing the fiduciary net position component of the net OPEB liability disclosed in the notes to the plan financial statements to that reported in the plan statement of fiduciary net position

14.146 The following are examples of substantive procedures for auditing the net OPEB liability for single employers when plan management prepares a schedule of OPEB amounts that includes total OPEB liability, fiduciary net position, and net OPEB liability, for which the plan's management engages its auditor to obtain reasonable assurance and report on net OPEB liability in accordance with AU-C section 805:

a. Evaluating whether the plan auditor's report on the schedule of OPEB amounts is adequate and appropriate for the employer auditor's purposes

b. Evaluating whether the plan auditor has the necessary competence and objectivity for the employer auditor's purposes

> ***Emphasis Point***
>
> The employer auditor would also review the plan auditor's report and any related opinion modifications and assess other matters discussed in the report.

Fiduciary Net Position (Component of Net OPEB Liability)—Agent Employers

14.147 The following are examples of substantive procedures for auditing the fiduciary net position component of net OPEB liability for agent employers based on information obtained from the plan (see recommendations discussed in appendix A of chapter 13, adapted as appropriate for agent OPEB plans):

a. Obtaining an audited schedule of changes in fiduciary net position by employer from the plan for the measurement period and performing the following procedures on amounts specific to the employer:

   i. Agreeing beginning fiduciary net position for the employer to the prior year audited financial statements

   ii. Verifying the completeness and accuracy of the employer and employee contributions (if applicable) attributed to the employer

   iii. Performing analytical procedures over benefit payments by developing an expectation based on prior year benefit payments adjusted for changes in employer census data

   iv. Performing analytical procedures on investment income and administrative expense by developing an expectation based on total investment income and administrative expense for the plan as a whole multiplied by the employer's relative percentage of fiduciary net position

   v. Recomputing ending fiduciary net position

b. Determining whether the plan engaged an auditor to opine on the schedule of changes in fiduciary net position by employer either through (i) an opinion on the schedule as a whole combined with a type 2 SOC 1 report on the controls over the calculation and allocation of additions and deductions to employer accounts or (ii) an opinion on each employer column in the schedule *c.* Evaluating whether the plan auditor's report and accompanying schedule are adequate and appropriate for the employer auditor's purposes

d. Reconciling totals in the schedule of OPEB amounts in paragraph 14.147*a* to those reported in the audited plan financial statements

Emphasis Point

Before using the work of the plan auditor as evidence, regardless of whether the plan auditor opined on the schedule of changes in fiduciary net position as a whole with a type 2 SOC 1 report or on each employer column, the employer auditor should evaluate whether the plan auditor's report and accompanying schedule are adequate and appropriate for the employer auditor's purposes. For purposes of this evaluation, the employer auditor may review the plan auditor's report and any related opinion modifications and assess other matters discussed in the report. If a type 2 SOC 1 report is issued, employer auditors should apply the guidance in AU-C section 402 to properly utilize the report. Paragraph .13*a* of AU-C section 402 requires when determining the sufficiency and appropriateness of the audit evidence provided by a type 2 SOC 1 report, the employer auditor should be satisfied that the auditor providing the type 2 SOC 1 report is competent and independent from the plan.

Deferred Outflows of Resources and Deferred Inflows of Resources (Single and Agent Employers)

14.148 The following are examples of substantive procedures for auditing deferred outflows of resources and deferred inflows of resources for single and agent employers:

a. Obtaining a detailed schedule of deferred outflows of resources and deferred inflows of resources by type and period for the employer and performing the following:

i. Agreeing recognition (amortization) schedules and recognition (amortization) periods for prior period deferral amounts to prior year working papers and audited financial statements, if applicable

ii. Recalculating the current year gross incremental deferrals for differences between actual and expected experience and changes in assumptions based on information in the actuarial valuation report used to measure the net OPEB liability

iii. Recalculating the current year gross incremental deferral for the difference between projected and actual earnings on OPEB plan investments for the measurement period

iv. Recalculating the recognition (amortization) amount for the current period incremental deferrals for differences between actual and expected experience and changes in assumptions by dividing the gross incremental deferrals by the current year amortization period

v. Recalculating the recognition (amortization) amount for the current period deferral for differences between projected and actual earnings on OPEB plan investments by dividing the gross incremental deferral by five (years)

vi. Verifying contributions made after the measurement date and before the employer's year-end and comparing to amount reported as deferred outflows of resources

vii. Recalculating the mathematical accuracy of the total deferred outflows of resources and deferred inflows of resources by type as of the measurement date and the total recognition (amortization) for measurement period based on the components tested in procedures described in items *a*(i)–(vi)

Emphasis Point

If OPEB amounts are allocated between the primary government and component units or to proprietary and fiduciary funds using an allocation methodology similar to employers participating in a cost-sharing plan, there may be two additional types of deferrals related to (*a*) changes in proportion and (*b*) differences between actual contributions and the proportionate share of total contributions from all employers (see exhibit 14-4). Paragraph 14.186*k* provides suggested procedures on employer-specific deferred outflows of resources and deferred inflows of resources specific to cost-sharing employers that may be adapted for this purpose.

OPEB Expense (Single and Agent Employers)

14.149 The following are examples of substantive procedures for auditing OPEB expense for single and agent employers:

a. Obtaining a detailed schedule of OPEB expense for the measurement period

b. Comparing total service cost to the actuarial valuation used to measure the total OPEB liability

c. Comparing employee contributions to audited plan financial statements, if applicable, or contributions tested in conjunction with the substantive procedures described in paragraph 14.144 that correspond to the measurement period

d. Recalculating interest on total OPEB liability by multiplying beginning total OPEB liability, adjusted for service cost and actual benefit payments, by the discount rate

e. Verifying changes in benefit terms to the actuarial valuation report and procedures performed related to the total OPEB liability in paragraph 14.141

f. Comparing plan administrative costs to audited plan financial statements, if applicable, or administrative costs tested in conjunction with the substantive procedures described in paragraph 14.144 that correspond to the measurement period

g. Recalculating projected earnings on plan investments by multiplying beginning plan fiduciary net position, adjusted for contributions, actual benefit payments, and actual administrative expenses, by the long-term expected rate of return on plan investments

> ***Emphasis Point***
>
> Projected earnings on OPEB plan investments should consider changes in invested amounts and should be calculated as the return that actual invested amounts would have earned at the assumed rate of return over the measurement period. Paragraph 40 of GASB Statement No. 75 requires that the long-term expected rate of return should be net of investment expense, but not net of administrative expense, and should reflect the expectation of the rate as of the beginning of the measurement period.

h. Reconciling amounts of deferred outflows of resources and deferred inflows of resources recognized as OPEB expense based on procedures performed in paragraph 14.148

i. Recalculating the mathematical accuracy of total OPEB expense based on the individual components

Part III—Employer Accounting, Financial Reporting, and Auditing Considerations for Defined Benefit OPEB Plans Administered Through a Qualifying Trust: Cost-Sharing Employers

> ***Emphasis Point***
>
> Part III of this chapter addresses specific accounting and auditing considerations for employers participating in cost-sharing multiple-employer defined benefit OPEB plans in accordance with GASB Statement No. 75 when the OPEB plan is administered through a qualifying trust. Part III refers to suggested solutions for cost-sharing multiple-employer defined benefit pension plans discussed in appendix B of chapter 13. The suggested solutions in appendix B of chapter 13 may be adapted as appropriate for cost-sharing OPEB plans. Although the guidance in appendix B in chapter 13 is integral to the audit of the employer's financial statements, the appendix is an *other auditing publication* and is nonauthoritative.
>
> If an OPEB plan is not administered through a qualifying trust, auditors of participating employers should follow the guidance in part IV.

Accounting and Financial Reporting Considerations

Recognition and Measurement in Financial Statements Prepared Using Economic Resources Measurement Focus and Accrual Basis of Accounting (No Special Funding Situation)

14.150 Governments (employers) that provide defined benefit OPEB through a cost-sharing multiple-employer (cost-sharing) plan that is administered through a qualifying trust are required to report their proportionate shares of the plan's collective net OPEB liability, OPEB expense, and certain deferred outflows of resources and deferred inflows of resources (OPEB amounts) in their financial statements in accordance with GASB Statement No. 75.

Proportionate Share of Collective Net OPEB Liability[17]

14.151 Paragraph 59 of GASB Statement No. 75 requires that a liability be recognized for the employer's proportionate share of the collective net OPEB liability, measured as of a date (measurement date) no earlier than the end of the employer's prior fiscal year, consistently applied from period-to-period.

> ***Emphasis Point***
>
> Based on the need for information from the OPEB plan, the employer will likely select a measurement date that coincides with the fiscal year-end of the plan.

14.152 Paragraph 59 of GASB Statement No. 75 requires that the employer's proportionate share of the collective net OPEB liability be measured by

a. determining the employer's proportion—a measure of the proportionate relationship of (i) the employer (and, to the extent associated with the employer, nonemployer contributing entities, if any, that provide support for the employer but that are not in a special funding situation) to (ii) all employers and all nonemployer contributing entities. The basis for the employer's proportion should be consistent with the manner in which contributions to the OPEB plan, excluding those to separately finance specific liabilities of an individual employer to the OPEB plan, are determined. The use of the employer's projected long-term contribution effort to the OPEB plan (including that of nonemployer contributing entities that provide support for the employer but that are not in a special funding situation) as compared to the total projected long-term contribution effort of all employers and all nonemployer contributing entities to determine the employer's proportion is encouraged.

b. multiplying the collective net OPEB liability by the employer's proportion calculated in item *a*.

14.153 Paragraph 60 of GASB Statement No. 75 states that to the extent that different contribution rates are assessed based on separate relationships that constitute the collective net OPEB liability (for example, separate rates are calculated based on an internal allocation of liabilities and assets for different classes or groups of employees), the determination of the employer's proportionate share of the collective net OPEB liability should be made in a manner that reflects those separate relationships.

14.154 Paragraph 61 of GASB Statement No. 75 requires that the employer's proportion be established as of the measurement date, unless the employer's proportion is actuarially determined, in which case, a proportion established at the date of the actuarial valuation used to determine the collective net OPEB liability may be used.

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[17] In this guide, references to a net OPEB liability also apply to situations in which the fiduciary net position exceeds the total OPEB liability resulting in a net OPEB asset.

> ***Emphasis Point***
>
> Paragraph 59 of GASB Statement No. 75 requires that the basis for the employer's proportion be consistent with the manner in which contributions to the plan are determined. Although GASB Statement No. 75 encourages an allocation method based on an employer's projected long-term contribution effort to the plan as compared to the total projected long-term contribution efforts of all employers contributing to the plan (that is, the actuarial method), the standard allows for other allocation methods to be used, including allocations based on historical measures, such as actual contributions. Allocations based on historical measures are likely to be more easily substantiated than the actuarial method. However, the use of such a historical measure may not be appropriate in certain circumstances.

Collective OPEB Expense, Deferred Outflows of Resources, and Deferred Inflows of Resources

14.155 Paragraph 63 of GASB Statement No. 75 requires that OPEB expense, as well as deferred outflows of resources and deferred inflows of resources related to OPEB, be recognized for the employer's proportionate share of collective OPEB expense and collective deferred outflows of resources and deferred inflows of resources related to OPEB. The employer's proportionate share should be determined using the employer's proportion of the collective net OPEB liability.

Change in Proportion

14.156 In accordance with paragraph 64 of GASB Statement No. 75, if there is a change in the employer's proportion of the collective net OPEB liability since the prior measurement date, the net effect of that change on the employer's proportionate share of the collective net OPEB liability and collective deferred outflows of resources and deferred inflows of resources related to OPEB, determined as of the beginning of the measurement period, should be recognized in the employer's OPEB expense, beginning in the current reporting period, using a systematic and rational method over a closed period.

14.157 For this purpose, the length of the expense recognition period should be equal to the average of the expected remaining service lives of all employees that are provided with OPEB through the OPEB plan (active employees and inactive employees) determined as of the beginning of the measurement period. The amount not recognized in the employer's OPEB expense should be reported as a deferred outflow of resources or deferred inflow of resources.

Contributions During the Measurement Period

14.158 Paragraph 65 of GASB Statement No. 75 states that for contributions to the OPEB plan other than those to separately finance specific liabilities of an individual employer or nonemployer contributing entity to the OPEB plan, the difference during the measurement period between the following should be recognized in the employer's OPEB expense, beginning in the current reporting period, using a systematic and rational method over a closed period:

- *a.* The total amount of such contributions from the employer (and amounts associated with the employer from nonemployer contributing entities that are not in a special funding situation) *b.* The amount of the employer's proportionate share of the total of such contributions from all employers and all nonemployer contributing entities

14.159 For this purpose, the length of the expense recognition period should be equal to the average of the expected remaining service lives of all employees that are provided with OPEB through the OPEB plan (active employees and inactive employees) determined as of the beginning of the measurement period. The amount not recognized in the employer's OPEB expense should be reported as a deferred outflow of resources or deferred inflow of resources related to OPEB.

14.160 Paragraph 67 of GASB Statement No. 75 states that for contributions to the OPEB plan to separately finance specific liabilities of the individual employer to the OPEB plan, the difference during the measurement period between the following should be recognized in the employer's OPEB expense:

a. The amount of such contributions from the employer (and amounts associated with the employer from nonemployer contributing entities that are not in a special funding situation)

b. The amount of the employer's proportionate share of the total of the contributions in item *a*, determined using the employer's proportion of the collective net OPEB liability

Employer Contributions After Measurement Date

14.161 Paragraph 68 of GASB Statement No. 75 requires contributions to the OPEB plan from the employer subsequent to the measurement date of the net OPEB liability and before the end of the reporting period be reported as a deferred outflow of resources related to OPEB.

Collective Net OPEB Liability

14.162 Paragraph 70 of GASB Statement No. 75 requires that the collective net OPEB liability be measured as the portion of the actuarial present value of projected benefit payments that is attributed to past periods of employee service (total OPEB liability) for the plan as a whole, net of the OPEB plan's fiduciary net position. The assumptions used in measuring the total OPEB liability should be the same as those used for the plan, as discussed in part I of this chapter. The OPEB plan's fiduciary net position component of net OPEB liability should be determined using the same valuation methods that are used by the OPEB plan for purposes of preparing its statement of fiduciary net position.

14.163 When the underlying actuarial valuation is as of a date prior to the required measurement date, paragraph 71 of GASB Statement No. 75 requires the use of update procedures to roll forward the valuation to the measurement date for the employer's reporting. The employer may roll forward an actuarial valuation performed as of a date no more than 30 months and 1 day earlier than the employer's most recent fiscal year-end to the employer's measurement date. Professional judgment should be used to determine the specific update procedures to be used, and consideration should be given to whether a new actuarial valuation is needed as discussed in paragraph 71.

> ***Emphasis Point***
>
> Employers should work collaboratively with the plan to determine the timing and frequency of actuarial valuations, especially if the plan chooses to perform actuarial valuations on a biennial basis. GASB Statement No. 75 requires the total OPEB liability for employers be determined by an actuarial valuation performed as of a date no more than 30 months and 1 day from the employer's most recent fiscal year-end. It is possible for a plan to be in compliance with the requirements of GASB Statement No. 75 (for example, actuarial valuation within 24 months of the plan's fiscal year-end), but the date of that valuation could be greater than 30 months and 1 day from the employer's most recent fiscal year-end, which would not be in compliance with the requirements of GASB Statement No. 75.

14.164 The collective OPEB expense and collective deferred outflows of resources and deferred inflows of resources related to OPEB that are required to be recognized by an employer primarily result from changes in the components of the collective net OPEB liability—that is, changes in the collective total OPEB liability and in the OPEB plan's fiduciary net position. Most changes in the collective net OPEB liability are included in the collective OPEB expense in the period of the change. For example, changes in the collective total OPEB liability resulting from current-period service cost, interest on the collective total OPEB liability, and changes of benefit terms are required to be recognized as collective OPEB expense in the current reporting period. Projected earnings on the OPEB plan's investments also are required to be included in the determination of the collective OPEB expense in the current reporting period. exhibit 14-4 of this chapter provides a summary of the various components of OPEB expense.

14.165 Paragraph 86 of GASB Statement No. 75 states that changes in the collective net OPEB liability should be included in the collective OPEB expense in the current measurement period except as follows:

a. If the alternative measurement method is not used to measure the total OPEB liability, each of the following should be recognized in collective OPEB expense, beginning in the current measurement period, using a systematic and rational method over a closed period equal to the average of the expected remaining service lives of all employees that are provided with OPEB through the OPEB plan (active employees and inactive employees) determined as of the beginning of the measurement period:

   i. Differences between expected and actual experience with regard to economic or demographic factors (differences between expected and actual experience) in the measurement of the total OPEB liability

   ii. Changes of assumptions about future economic or demographic factors or of other inputs (changes of assumptions or other inputs)

   The portion of (i) and (ii) not recognized in collective OPEB expense should be included in collective deferred outflows of resources or deferred inflows of resources related to OPEB.

b. The difference between projected and actual earnings on OPEB plan investments should be included in collective OPEB expense using a systematic and rational method over a closed five-year period, beginning in the current measurement period. The amount not included in collective OPEB expense should be included as deferred outflows of resources or deferred inflows of resources related to OPEB. Collective deferred outflows of resources and deferred inflows of resources arising from differences between projected and actual OPEB plan investment earnings in different measurement periods should be aggregated and included as a net deferred outflow of resources related to OPEB or a net deferred inflow of resources related to OPEB.

c. Contributions to the OPEB plan from employers or nonemployer contributing entities should not be included in collective OPEB expense.

Allocation of OPEB Amounts to Funds or Departments, or Both

14.166 GASB Statement No. 75 does not establish specific requirements for allocation of the net OPEB liability or other OPEB-related amounts to individual funds or departments. However GASB IG 2015-1 question 5.129.1, which addresses the allocation of net pension liability under GASB Statement No. 68, states the following:

> For proprietary and fiduciary funds, consideration should be given to NCGA Statement 1, *Governmental Accounting and Financial Reporting Principles*, paragraph 42, as amended, which requires that long-term liabilities that are directly related to and expected to be paid from those funds be reported in the statement of net position or statement of fiduciary net position, respectively.

The guidance in item 5.129.1 is also relevant for employers participating in defined benefit OPEB plans. Accordingly, when governments allocate OPEB amounts to funds or departments, or both, the allocation methodology described for employers participating in cost-sharing plans would be appropriate for such purpose. Such an allocation approach may result in the recognition of additional deferred outflows of resources or deferred inflows of resources related to changes in proportion from year-to-year.

Recognition and Measurement in Financial Statements Prepared Using Current Financial Resources Measurement Focus and Modified Accrual Basis of Accounting

14.167 In financial statements prepared using the current financial resources measurement focus and modified accrual basis of accounting, paragraph 87 of GASB Statement No. 75 specifies that a net OPEB liability should be recognized to the extent the liability is normally expected to be liquidated with expendable available financial resources. OPEB expenditures should be recognized equal to the total of (*a*) amounts paid by the employer to the OPEB plan and (*b*) the change between the beginning and ending balances of amounts normally expected to be liquidated with expendable available financial resources. Net OPEB liabilities are normally expected to be liquidated with expendable available financial resources to the extent that benefit payments have matured—that is, benefit payments are due and payable, and the OPEB plan's fiduciary net position is not sufficient for payment of those benefits.

Note Disclosures and Required Supplementary Information

14.168 Paragraphs 91–96 of GASB Statement No. 75 address the note disclosures to the financial statements of cost-sharing employers. The following are among the required disclosures:

- Plan description
- Employer's proportionate share (amount) of collective net OPEB liability
- Employer's proportion (percentage) of collective net OPEB liability (including the basis on which it was determined) and change in its proportion since prior measurement date
- Significant assumptions used to measure total OPEB liability, including inflation, healthcare cost trend rates, salary changes (if applicable), ad hoc postemployment benefit changes (including ad hoc COLAs), sharing of benefit-related costs with inactive plan members, discount rate, and mortality
- Measurement date of collective net OPEB liability and date of actuarial valuation on which the total OPEB liability is based
- Information about plan fiduciary net position

Emphasis Point

Paragraph 95 of GASB Statement No. 75 requires note disclosures, including information about the plan's assets, deferred outflows of resources, liabilities, deferred inflows of resources, and fiduciary net position (that is, condensed financial information of the plan). However, if (*a*) a financial report that includes disclosure about the elements of the OPEB plan's basic financial statements is available on the Internet, either as a stand-alone financial report or included as a fiduciary fund in the financial report of another government and (*b*) information is provided about how to obtain the report, reference may instead be made to the other report for these disclosures. In this circumstance, other specific disclosures apply as discussed in paragraph 95.

- Amount of OPEB expense recognized by employer in reporting period
- Employer's balances of deferred outflows of resources and deferred inflows of resources related to OPEB by type

14.169 In addition, cost-sharing employers have to present certain 10-year schedules of RSI[18] and related notes as discussed in paragraphs 97–98 of GASB Statement No. 75, including information on the employer's proportionate share (amount) of the collective net OPEB liability and information on contributions.

Special Funding Situations

14.170 For OPEB plans that are administered through a qualifying trust, GASB Statement No. 75 defines *special funding situations* as circumstances in which a nonemployer entity is legally responsible for making contributions directly to an OPEB plan (including making benefit payments as the OPEB

[18] See footnote 6.

comes due for benefits provided through such a plan) that is used to provide OPEB to the employees of another entity or entities and either of the following criteria is met: (*a*) the amount of contributions for which the nonemployer entity is legally responsible is not dependent upon one or more events unrelated to OPEB or (*b*) the nonemployer is the only entity with a legal obligation to make contributions directly to an OPEB plan.

14.171 An employer that has a special funding situation for defined benefit OPEB is required to recognize an OPEB liability and deferred outflows of resources and deferred inflows of resources related to OPEB with adjustments for the involvement of nonemployer contributing entities. The employer is required to recognize its proportionate share of the collective OPEB expense, as well as additional OPEB expense and revenue related to the expense recognized by the nonemployer contributing entities. The employer is required to disclose in the notes to the financial statements information about the amount of support provided by nonemployer contributing entities and present similar information about the involvement of those entities in the 10-year schedules of RSI. See paragraphs 109–115 of GASB Statement No. 75 for specific accounting and disclosure requirements related to special funding situations for cost-sharing employers.

14.172 The recognition and measurement of liabilities, deferred outflows of resources and deferred inflows of resources, and expenses by a governmental nonemployer contributing entity in a special funding situation for defined benefit OPEB is similar to that of cost-sharing employers. See paragraphs 116–137 of GASB Statement No. 75 for specific accounting and disclosure requirements related to special funding situations for nonemployer contributing entities.

Auditing Considerations for Cost-Sharing Employers

14.173 This section of the chapter discusses considerations, including describing the relevant assertions when auditing the OPEB information included in the employer's financial statements. This section does not include all risks or procedures that could apply to such audits in accordance with generally accepted auditing standards; instead, it focuses on specific considerations for testing certain financial statement elements of the employer's financial statements affected by defined benefit OPEB plans, including net OPEB liability, deferred outflows of resources, deferred inflows of resources, and OPEB expense. The example substantive audit procedures are not considered required procedures, nor are they all-inclusive.

Determining Audit Strategy

14.174 It is important to note that regardless of the type of OPEB plan, the plan is not considered a component of the employer for purposes of AU-C section 600, similar to defined benefit pension plans as discussed in Interpretation No. 1 of AU-C section 600. Although this interpretation is specific to pension plans, the concepts covered in this interpretation also apply to OPEB plans.

14.175 Therefore, the employer auditor is solely responsible for determining the sufficiency and appropriateness of audit evidence necessary to reduce audit risk to an appropriately low level for the OPEB amounts in the audit of the employer's financial statements. That is, the audited financial statements of the plan will not, by themselves, provide the employer auditor sufficient appropriate audit evidence to support the components of net OPEB liability (that is, total OPEB liability and plan fiduciary net position). Absent additional evidence obtained, the employer auditor would not likely be able to accumulate sufficient appropriate audit evidence to support the OPEB amounts and disclosures in the employer's financial statements.

14.176 Each cost-sharing employer will be challenged about how to obtain all information to support its proportionate share of collective OPEB amounts reported in the employer's financial statements (that is, the collective net OPEB liability, deferred outflows of resources, deferred inflows of resources, and OPEB expense). The employer's proportionate share of the collective OPEB amounts is a measure of the proportionate relationship of the employer to all employers and nonemployer contributing entities.

14.177 Similarly, employer auditors will be challenged in terms of obtaining sufficient appropriate evidence regarding the OPEB amounts included in employer financial statements. AU-C section 500 states that the objective of the auditor is to design and perform audit procedures that enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.

14.178 Appendix B of chapter 13 provides a two-part approach to address the challenges of employers and their auditors for cost-sharing pension plans. This guidance is relevant and may be applied and adapted as considered appropriate for cost-sharing OPEB plans. The first part addresses employer allocations. The second part addresses a method to obtain reasonable assurance on the total net pension liability, total deferred outflows of resources, total deferred inflows of resources, and total pension expense for the sum of all participating entities. Appendix B of chapter 13 provides detailed explanations and illustrations.

14.179 The substantive audit procedures included in this chapter for cost-sharing employers assume that the cost-sharing plans provide employers with the recommended information and related audit reports discussed in appendix B in chapter 13, adapted as appropriate for defined benefit OPEB plans.

Emphasis Point

In accordance with Interpretation No. 2, "Auditor of Participating Employer in a Governmental Cost-Sharing Multiple-Employer Pension Plan" (AICPA, *Professional Standards*, AU-C sec. 9500 par. .23–.29), of AU-C section 500 , it is important for employer auditors to understand that obtaining the audited plan financial statements and additional unaudited information provided by the plan's management to calculate the employer's net pension liability will likely not provide sufficient appropriate audit evidence to support the relevant assertions in the employer's financial statements. Although this interpretation is specific to pension plans, the concepts in the interpretation also apply to OPEB plans.

Census Data

14.180 As discussed in paragraphs 14.14–.16, certain financial statement elements of cost-sharing employers that participate in defined benefit OPEB plans (that is, net OPEB liability, deferred outflows of resources, deferred inflows of resources, and OPEB expense) are dependent on demographic data (census data) of the members. The employer auditor's consideration of the relevant financial statement assertions that are dependent on census data begins with understanding the processes and internal control used by the employer and the plan to support the completeness and accuracy of the significant elements of census data that are provided to the actuary. In a cost-sharing plan, individual employer census data affects the collective OPEB amounts reported by the plan. Certain census data elements, such as contributions, directly affect the individual employer's proportionate share if used as the basis for allocation. Other census data elements affect the plan as a whole and are attributable to individual employers to the extent they affect the collective OPEB amounts to be allocated.

14.181 *Significant elements of census data* are those elements that, either individually or when combined with other elements, could result in a material misstatement to one or more elements of the employer's financial statements (that is, net OPEB liability, deferred outflows of resources, deferred inflows of resources, and OPEB expense). Significant elements of census data may include some or all of the following:

- *a.* Name
- *b.* Social Security number
- *c.* Date of birth
- *d.* Date of hire
- *e.* Marital status
- *f.* Dependents
- *g.* Service credits (periods of time worked)
- *h.* Class of employee
- *i.* Position or job code (or both)
- *j.* Gender
- *k.* Date of termination or retirement
- *l.* Spouse's date of birth
- *m.* Employment status (active, inactive entitled to but not receiving benefits, retired).

The significance of some of these elements, all of these elements, or additional elements to any plan will be based on the impact that a particular census data element has on the measurement of a particular financial statement element. In a cost-sharing plan, as part of determining the significant elements of census data, it is important for the employer auditor to understand how the individual elements of census data affect the plan as a whole and the individual employers. Significant elements of census data from the perspective of the employer auditor include those elements that affect the OPEB amounts allocated to that specific employer. Employer auditors will obtain an understanding of the significant elements of census data that, either individually or when combined with other elements, could result in a material misstatement to the employer's financial statements.

> ***Emphasis Point***
>
> Many OPEB plans allow members to choose from more than one health care plan option through an annual open enrollment process (for example, an HMO, PPO, or traditional indemnity plan). Although the benefits election is not an element of census data, such elections are considered in the utilization assumptions by the actuary in projecting benefit (claims) costs in the actuarial valuation.

14.182 The underlying records that support the census data for cost-sharing plans are typically maintained by different parties. The underlying records of active members are typically maintained by the employers. The underlying records of plan members who are no longer employed by the employers (that is, inactive members) are typically maintained by the plan. The underlying records of active members (of the applicable individual employer) maintained by the employer for purposes of testing the *significant elements of census data* that were reported to the plan during the period could be tested by the employer auditor, but access to information for the census data maintained by the plan, as well as census data related to active plan members of other cost-sharing employers, necessitates additional support from the plan and plan auditor.

14.183 The employer auditor performs procedures to test the significant elements of census data reported to the plan, whereas the plan auditor performs procedures to test the significant elements of census data maintained by the plan as discussed in part I. The plan auditor performs procedures to test census data reported to the plan by the employers. The substantive procedures over census data (for both the employer and the plan auditor) are ordinarily based on a concept that focuses on testing incremental changes to the census data file since the prior actuarial valuation, assuming (*a*) the prior year plan financial statements were audited, (*b*) there were no modifications to the auditor's report in the prior year related to census data, and (*c*) the auditor has concluded there is no significant risk of material misstatement due to incomplete or inaccurate census data from prior years. These procedures would ordinarily cover the census data reported to the plan during 1) the year immediately preceding the actuarial valuation when the actuarial valuation is performed on an annual basis, or 2) the two-year period immediately preceding the actuarial valuation when the actuarial valuation is performed on a biennial basis.

Net OPEB Liability, Deferred Outflows of Resources and Deferred Inflows of Resources, and OPEB Expense for Cost-Sharing Employers

Relevant Assertions

14.184 The relevant assertions relating to net OPEB liability, deferred outflows of resources, deferred inflows of resources, and OPEB expense for cost-sharing employers include the following:

a. Member census data reported to the plan is complete and accurate.

b. Member census data accumulated and maintained by the plan is complete and accurate.

c. Actuarial assumptions used in computing the total OPEB liability are in accordance with GASB Statement No. 75 and the Actuarial Standards of Practice.

d. The employer's proportionate share of the collective OPEB amounts, including net OPEB liability, deferred outflows of resources and deferred inflows of resources and OPEB expense have been properly determined and recorded in the financial statements in accordance with GASB Statement No. 75 and in the proper period.

e. The employer's deferred outflows of resources and deferred inflows of resources for contributions made after the measurement date, changes in proportion, and differences between the employer's actual contributions and its proportionate share of all employer contributions have been properly determined and recorded in the financial statements in accordance with GASB Statement No. 75, in the proper period, and are properly disclosed.

Examples of Identified Risks of What Can Go Wrong at the Relevant Assertion Level

14.185 The following are examples of identified risks of what can go wrong at the relevant assertion level relating to net OPEB liability, deferred outflows of resources, deferred inflows of resources, and OPEB expense for cost-sharing employers:

a. Census data reported by the employer to the plan is not accurate and complete.

b. The actuary uses inappropriate assumptions or actuarial methods that are not in conformity with GASB Statement No. 75 and the Actuarial Standards of Practice, causing errors in the computation of total OPEB liability.

c. The collective OPEB amounts, including net OPEB liability, deferred outflows of resources and deferred inflows of resources and OPEB expense have not been properly determined in accordance with GASB Statement No. 75.

d. The employer's proportionate share of the collective OPEB amounts is not consistent with the manner in which the employer's contributions are made to the plan.

e. The plan auditor's report and accompanying schedule of employer allocations and schedule of OPEB amounts are not adequate or appropriate for the employer auditor's purposes (for example, opinion modification, opinion on the schedule as a whole and not the individual elements, employer or employer auditor, or both, not named in the report as a specified user).

f. The plan auditor engaged to report on the schedule of employer allocations and schedule of OPEB amounts does not have the necessary competence and objectivity for the employer auditor's purposes.

g. The amounts included in the schedule of employer allocations prepared by the plan specific to the employer, including the employer amount used in the allocation percentage (that is, the numerator of the calculation), are not accurate.

h. The amounts included in the schedule of OPEB amounts prepared by the plan specific to the employer are not accurate.

i. The employer-specific deferred outflows of resources and deferred inflows of resources (including contributions made after the measurement date, changes in proportion, and differences between the employer's actual contributions and its proportionate share of total employer contributions) have not been properly determined in accordance with GASB Statement No. 75.

Example Audit Procedures to Consider

14.186 The following are examples of substantive procedures for auditing net OPEB liability, deferred outflows of resources and deferred inflows of resources, and OPEB expense for cost-sharing employers based on the suggested two-part approach (excluding census data, which is discussed in paragraph 14.180):

a. Obtaining the actuarial valuation report used to measure the collective total OPEB liability for the plan as of the measurement date based on GASB Statement No. 75

> ***Emphasis Point***
>
> Plans often have different actuarial valuations performed for accounting (for example, accounting pursuant to GASB Statement No. 75) and funding (for example, actuarially determined contribution) purposes.

b. Evaluating the professional qualifications of the actuary, including his or her competence, capabilities, and objectivity as required by paragraph .08 of AU-C section 500 (If the actuary is not known to the auditor, consider other factors that might provide information regarding the actuary's qualifications, such as [i] the actuary's membership in a recognized professional organization, [ii] the number and types of OPEB plans served, including years of experience, and [iii] the opinion of other actuaries whom the auditor knows to be qualified regarding the actuary's professional qualifications.)

c. Reading the actuarial certification for potential exclusions from the scope of the actuary's work or qualifications on the actuary's certification relating to actuarial methods, actuarial assumptions, or census data

d. Determining whether the actuarial valuation was performed as of a date no more than 30 months and 1 day from the employer's fiscal year-end

e. Evaluating whether the methods and assumptions used in determining the total OPEB liability are in accordance with GASB Statement No. 75 and Actuarial Standards of Practice and are the same as those used by the plan

f. Obtaining the audited schedule of employer allocations and comparing and recalculating amounts specific to the employer to the employer's records

> ***Emphasis Point***
>
> Comparing and recalculating amounts used in the schedule of employer allocations is meant to address whether the amount or information reported to the plan that relates to the allocation was complete and accurate; whether

the amount reported by the plan (numerator) agrees to the employer's records; and that the calculation is mathematically accurate.

g. Obtaining the audited schedule of OPEB amounts and recalculating the allocated OPEB amounts for the employer by multiplying the collective OPEB amounts for the plan by the employer's proportionate share (allocation percentage)

h. Evaluating whether the plan auditor's report on the schedule of employer allocations and the schedule of OPEB amounts is adequate and appropriate for the employer auditor's purposes

Emphasis Point

If an employer makes contributions to separately finance specific liabilities of the individual employer, as discussed in paragraph 14.160, such contributions may or may not be reflected in the schedule of OPEB amounts. If not included in the schedule, alternative evidence is necessary to substantiate the amounts.

i. Evaluating whether the plan auditor has the necessary competence and objectivity for the employer auditor's purposes

j. Obtaining the audited plan financial statements and performing the following:

  i. Agreeing or reconciling net OPEB liability reported in the schedule of OPEB amounts in item *g* to the net OPEB liability disclosed in the notes to the plan financial statements

  ii. Agreeing the fiduciary net position component of the net OPEB liability disclosed in the notes to the plan financial statements to that reported in the plan statement of fiduciary net position

k. Obtaining a detailed schedule of employer-specific deferred outflows of resources and deferred inflows of resources by type (including contributions made after the measurement date, changes in proportion, and differences between the employer's actual contributions and its proportionate share of total employer contributions) and by period and performing the following:

  i. Testing contributions made after the measurement and before the employer's year-end and comparing to the amount reported as deferred outflows of resources

  ii. Agreeing recognition (amortization) schedules and recognition (amortization) periods for prior period deferral amounts to prior year working papers and audited financial statements

  iii. Recalculating the current year gross incremental deferrals for changes in proportion and differences between the employer's actual contributions and its proportionate share of total employer contributions

  iv. Recalculating the recognition (amortization) amount for the current period incremental deferrals for changes in proportion and differences between the employer's actual contributions and its proportionate share of total employer contributions, for example, by dividing the current respective gross incremental deferrals by the current year amortization period for the plan

l. Recalculating the mathematical accuracy of the total deferred outflows of resources and deferred inflows of resources by type as of the measurement date and the total recognition (amortization) for the measurement period based on the components tested in items *g* and *k*

m. Recalculating OPEB expense based on the employer's specific OPEB expense in the schedule of OPEB amounts from item *g* plus the recognition (amortization) amount of employer-specific deferred outflows of resources and deferred inflows of resources from item *k*

Census Data

Emphasis Point

As discussed in paragraph 14.183, the substantive procedures over census data (for both the employer and the plan auditor) are ordinarily based on a concept that focuses on testing incremental changes to the census data file during 1) the year immediately preceding the actuarial valuation date when actuarial valuations are performed on an annual basis, or 2) the two-year period immediately preceding the actuarial valuation when the actuarial valuations are performed on a biennial basis. These procedures would ordinarily cover the incremental census data reported to the plan (that is, changes to the census data file) during the applicable period. For example, if a plan has a fiscal year-end of June 30, 20X7, and uses a beginning of the year actuarial valuation as of July 1, 20X6 (which is rolled forward to the plan's fiscal year-end of June 30, 20X7), and actuarial valuations are performed on an annual basis, the focus of the procedures would ordinarily be over the incremental census data reported to the plan during the year ended June 30, 20X6. Additionally, the procedures should cover the entire year and not be limited to a specific point in time during the year.

If the plan performs biennial valuations, the census data to be tested for the July 1, 20X6, valuation would be that reported to the plan since the last valuation (that is, the two-year period ending June 30, 20X6).

Emphasis Point

Focusing on the risk of material misstatement to the employer, the employer auditor should design and perform audit procedures over the census data that are responsive to the risk of material misstatement at the assertion level. This will be dependent on both the nature of the plan and the risks at the employer level, including the employer's relative proportion of the collective OPEB amounts for the plan. For example, when collective OPEB amounts are allocated to participating employers based on the relative percentage of actual employer contributions to the plan and the employer constitutes a relatively small portion of the total plan, the employer auditor may determine that the audit procedures that are responsive to the assessed risks of material misstatement relate to the completeness and accuracy of census data that affects the calculation and reporting of the respective employer contributions. In contrast, when an employer constitutes a relatively large portion of the plan, the employer auditor may determine that the audit procedures that are responsive to the assessed risks of material misstatement relate to the completeness and accuracy of census data that affects both 1) the calculation and reporting of the respective employer contributions and 2) the collective OPEB liability for the plan. The employer auditor will determine the appropriate audit procedures to address these risks, which may include substantive procedures over cumulative OPEB reporting at the employer level or individual participant census data testing, or both.

14.187 The following are examples of substantive procedures for testing the completeness and accuracy of the census data reported to the plan (for active members) assuming certain census data elements present a potential risk of material misstatement to the employer:

a. Identifying the payroll registers and payroll cycles for all reporting units of the government

b. Obtaining the population of employer (payroll) transmission reports submitted to the plan during the period from the prior valuation to the current valuation and performing the following:

  i. Evaluating whether the population of employer (payroll) transmission reports received is complete based on an understanding of the employer's payroll registers and cycles

  ii. Selecting a sample of employer (payroll) transmission reports to verify the mathematical accuracy of reports and whether the correct contribution rates were used

c. Obtaining a list of new employees hired during the period from the prior valuation to the current valuation from the employer and performing the following procedures:

  i. Selecting a sample to determine that eligible new employees were appropriately enrolled in the plan and properly included in the employer (payroll) transmission reports

  ii. For each employee selected, verifying accuracy of the significant elements of census data reported to the plan upon enrollment to the payroll and personnel records

Emphasis Point

The employer auditor may need to obtain the enrollment forms or the equivalent information from the plan.

d. Obtaining a list of status changes during the period from the prior valuation to the current valuation (other than those reported through the employer [payroll] transmission reports) and selecting a sample to determine that they were appropriate based on the relevant plan criteria and underlying payroll and personnel records

e. Selecting a sample of active members and performing the following procedures:

> ***Emphasis Point***
>
> Consider selecting a sample from the employer's payroll registers throughout the year and a sample from the employer (payroll) transmission reports throughout the year.

i. Agreeing details included in the applicable employer (payroll) transmission report (for example, name, position or job code, periods of time worked, pensionable wages for the period, employer contribution for the period, and employee contribution for the period) to the payroll register (or vice versa), and agreeing the underlying information to the payroll and personnel records

ii. Evaluating whether the selected employee is eligible to participate in the plan based on the eligibility criteria included in the plan document (state statutes)

iii. Recalculating service credits

Part IV—Employer Accounting, Financial Reporting, and Auditing Considerations for Defined Benefit OPEB Plans That Are Not Administered Through a Qualifying Trust

> ***Emphasis Point***
>
> Part IV of this chapter addresses specific accounting and auditing considerations for governments whose employees are provided with OPEB through OPEB plans that are *not* administered through a qualifying trust. In these circumstances, there is no OPEB plan reporting (that is, a statement of fiduciary net position, a statement of changes in fiduciary net position, notes to basic financial statements, and required supplementary information for the OPEB plan), and any assets accumulated by the employer to pay plan benefits would be reported as assets of the employer, not the plan. Additionally, because there are no plan assets or fiduciary net position, employers report total OPEB liability instead of net OPEB liability.

Accounting and Financial Reporting Considerations

Recognition and Measurement in Financial Statements Prepared Using Economic Resources Measurement Focus and Accrual Basis of Accounting (No Special Funding Situation)

14.188 Governments (employers) that provide defined benefit OPEB through a plan that is not administered through a qualifying trust are required to recognize total OPEB liability, OPEB expense, and certain deferred outflows of resources and deferred inflows of resources (OPEB amounts) in their financial statements in accordance with GASB Statement No. 75. Although not explicitly stated in GASB Statement No. 75, each individual employer is considered to be participating in their own OPEB plan, similar to a single employer plan that is not administered through a qualifying trust. When a multiple-employer plan is not administered through a qualifying trust (for example, the plan assets are not restricted solely to paying OPEB for plan members), in accordance with paragraph 59 of GASB Statement No. 74, a government that holds the assets accumulated for OPEB purposes in a fiduciary capacity (that is, for other entities that are not included within the reporting entity) should report the assets in an agency fund.

Update 14-2 *Fiduciary Activities*

GASB Statement No. 84 establishes criteria for identifying and reporting fiduciary activities. The criteria for identification of fiduciary activities primarily focuses on (a) whether a government controls the assets of the fiduciary activity and (b) the beneficiaries with whom a fiduciary relationship exists.

Governments with activities meeting the criteria will present a statement of fiduciary net position and a statement of changes in fiduciary net position, with certain exceptions.

There are four classifications of fiduciary funds described in GASB Statement No. 84: (1) pension (and other employee benefit) trust funds, (2) investment trust funds, (3) private-purpose trust funds, and (4) custodial funds. Custodial funds should report fiduciary activities that are not held in a trust or equivalent arrangement that meets specific criteria. Note that agency funds will no longer be reported upon application of this statement.

The statement was issued in January 2017 and is effective for fiscal years beginning after December 15, 2018. Earlier application is encouraged.

Upon its effective date, GASB Statement No. 84 will affect the guidance in this chapter.

The full text of the statement is available on GASB's website at www.gasb.org.

Total OPEB Liability

14.189 Paragraph 146 of GASB Statement No. 75 requires that the total OPEB liability be measured as the portion of the actuarial present value of projected benefit payments that is attributed to past periods of employee service.[19] However, if an employer has fewer than 100 participants (active and inactive) provided with benefits through the OPEB plan as of the beginning of the measurement period, the total OPEB liability *may* be measured using the alternative measurement method discussed in paragraphs 225–226 of GASB Statement No. 75. The total OPEB liability should be measured as of a date (measurement date) no earlier than the end of the employer's prior fiscal year, consistently applied from period-to-period.

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[19] For purposes of applying paragraphs 146–156 in conformity with paragraph 172, paragraph 193, or paragraph 203 of GASB Statement No. 75, the term *Total OPEB Liability* applies to the collective total OPEB liability.

> ***Emphasis Point***
>
> As discussed in part II, employers that participate in an OPEB plan that is administered through a qualifying trust will likely select a measurement date that coincides with the fiscal year-end of the plan because of the need to obtain audited information (for example, fiduciary net position) from the plan. However, when an OPEB plan is not administered through a qualifying trust, there is no similar consideration (that is, selecting a measurement data that coincides with the fiscal year-end of the plan) because the employer does not need to obtain audited information (for example, fiduciary net position) from the plan.

14.190 When the underlying actuarial valuation is as of a date prior to the required measurement date, paragraph 147 of GASB Statement No. 75 requires the use of update procedures to roll forward the valuation to the measurement date for the employer's reporting. The employer may roll forward an actuarial valuation performed as of a date no more than 30 months and 1 day earlier than the employer's most recent fiscal year-end to the employer's measurement date. Professional judgment should be used to determine the specific update procedures to be used. If significant changes occur between the actuarial valuation date and the measurement date, consideration should be given to whether a new actuarial valuation is needed.

OPEB Expense, Deferred Outflows of Resources, and Deferred Inflows of Resources

14.191 The OPEB expense, deferred outflows of resources, and deferred inflows of resources related to OPEB that are required to be recognized by an employer primarily result from changes in the components of the total OPEB liability during the measurement period—that is, changes in the total OPEB liability. Most changes in the total OPEB liability during the measurement period are included in OPEB expense. For example, changes in the total OPEB liability during the measurement period resulting from current-period service cost, interest on the total OPEB liability, and changes of benefit terms are required to be recognized as OPEB expense in the current reporting period. Exhibit 14-5 of this chapter provides a summary of the various components of OPEB expense.

14.192 Specifically, paragraph 157 of GASB Statement No. 75 states that changes in the total OPEB liability should be recognized in OPEB expense in the current reporting period except as follows:

a. If the alternative measurement method is not used to measure the total OPEB liability, each of the following should be recognized in OPEB expense, beginning in the current reporting period, using a systematic and rational method over a closed period equal to the average of the expected remaining service lives of all employees that are provided with OPEB through the OPEB plan (active employees and inactive employees) determined as of the beginning of the measurement period:

    i. Differences between expected and actual experience with regard to economic or demographic factors (differences between expected and actual experience) in the measurement of the total OPEB liability

   ii. Changes of assumptions about future economic or demographic factors or of other inputs (changes of assumptions or other inputs)

   The portion of (i) and (ii) not recognized in OPEB expense should be reported as deferred outflows of resources or deferred inflows of resources related to OPEB.

b. Amounts paid by the employer for OPEB as the benefits come due should not be recognized in OPEB expense.

c. Amounts paid by nonemployer contributing entities that are not in a special funding situation for OPEB as the benefits come due should be recognized as revenue.

14.193 Paragraph 159 of GASB Statement No. 75 requires that deferred outflows of resources related to OPEB be reported for (*a*) amounts paid by the employer for OPEB as the benefits come due subsequent to the measurement date of the total OPEB liability and before the end of the reporting period (excluding amounts associated with the employer from nonemployer contributing entities that are not in a special funding situation) and (*b*) amounts incurred by the employer for OPEB administrative expenses subsequent to the measurement date of the total OPEB liability and before the end of the reporting period.

Exhibit 14-5: Components of OPEB Expense

Components of OPEB Expense	*Impact on OPEB Expense*
Service cost	Increase
Interest on total OPEB liability	Increase
Changes in benefit terms	Increase or Decrease
Employer administrative costs	Increase
Recognition (amortization) of deferred outflows of resources:	
Differences between expected and actual experience	Increase
Changes of assumptions	Increase
Changes in proportion(1)	Increase
Differences between actual OPEB payments and proportionate share of OPEB payments(1)	Increase
Recognition (amortization) of deferred inflows of resources:	
Differences between expected and actual experience	Decrease
Changes of assumptions	Decrease
Changes in proportion(1)	Decrease
Differences between actual OPEB payments and proportionate share of OPEB payments(1)	Decrease

(1) Deferred outflows of resources and deferred inflows of resources related to changes in proportion and differences between actual OPEB payments and proportionate share of total OPEB payments may be applicable to employers when allocating OPEB amounts to funds, departments, or component units.

Allocation of OPEB Amounts Between Primary Government and Discretely Presented Component Units

14.194 When reporting OPEB in stand-alone financial statements of primary governments and component units that provide OPEB through the same defined benefit OPEB plan, governments (employers) should follow the guidance in paragraphs 172–192 of GASB Statement No. 75. This guidance is similar to that described for cost-sharing employers in part III. Accordingly, OPEB liability, deferred outflows of resources, deferred inflows of resources, and OPEB expense should be recognized for the government's (primary government's or component unit's) proportionate share of the respective collective amounts for the plan as a whole. Additional deferred outflows of resources and deferred inflows of resources that result from the following may be relevant:

- Changes in proportion as discussed in paragraph 178 of GASB Statement No. 75
- Differences between the total amounts of payments for OPEB as the benefits become due and the amount of the government's proportionate share of the total of such payments from all entities as discussed in paragraph 179 of GASB Statement No. 75

Additionally, OPEB expense should be recognized for costs incurred by the government related to the administration of OPEB and the total nonemployer contributing entities' expenses for costs incurred related to the administration of OPEB associated with the government as discussed in paragraph 180 of GASB No. 75.

Allocation of OPEB Amounts to Funds or Departments, or Both

14.195 GASB Statement No. 75 does not establish specific requirements for allocation of the total OPEB liability or other OPEB-related amounts to individual funds or departments. However, IG 2015-1 question 5.161.2, which addresses the allocation of net pension liability under GASB Statement No. 68, states the following:

> For proprietary and fiduciary funds, consideration should be given to National Council on Governmental Accounting (NCGA) Statement 1, *Governmental Accounting and Financial Reporting Principles*, paragraph 42, as amended, which requires that long-term liabilities that are "directly related to, and expected to be paid from" those funds be reported in the statement of net position or statement of fiduciary net position, respectively.

The guidance in GASB IG 2015-1 question 5.129.1 is also relevant for employers participating in defined benefit OPEB plans. Accordingly, when governments allocate OPEB amounts to funds or departments, or both, the allocation methodology described for employers participating in cost-sharing OPEB plans is as discussed in paragraph 14.194.

Recognition and Measurement in Financial Statements Prepared Using Current Financial Resources Measurement Focus and Modified Accrual Basis of Accounting

14.196 In financial statements prepared using the current financial resources measurement focus and modified accrual basis of accounting, paragraph 161 of GASB Statement No. 75 specifies that a total OPEB liability (or, if an employer has a special funding situation, a proportionate share of the collective total OPEB liability) should be recognized to the extent the liability is normally expected to be liquidated with expendable available financial resources. OPEB expenditures should be recognized equal to the total of (*a*) amounts paid by the employer for OPEB as the benefits come due and (*b*) the change between the beginning and ending balances of amounts normally expected to be liquidated with expendable available financial resources. A total OPEB liability (or, if an employer has a special funding situation, a proportionate share of the collective total OPEB liability) is normally expected to be liquidated with expendable available financial resources to the extent that benefit payments have matured—that is, benefit payments are due and payable.

Note Disclosures and Required Supplementary Information

14.197 Paragraphs 162–169 of GASB Statement No. 75 address the note disclosures in the financial statements of employers. The following are among the required disclosures:

- Plan description (including the fact that there are no assets accumulated in a trust that meets the requirement of paragraph 4 of GASB Statement No. 75)
- Changes in total OPEB liability (including beginning balances of the components of total OPEB liability, effects during the reporting period of items that change the components of total OPEB liability, and ending balances of the components of total OPEB liability)
- Significant assumptions used to measure the total OPEB liability, including inflation, healthcare cost trend rates, salary changes (if applicable), ad hoc postemployment benefit changes (including ad hoc COLAs), sharing of benefit-related costs with inactive plan members, discount rate, and mortality)
- Measurement date of the total OPEB liability and the date of the actuarial valuation or alternative measurement method calculation on which the total OPEB liability is based
- Amount of OPEB expense recognized by the employer in the reporting period
- Employer's balances of deferred outflows of resources and deferred inflows of resources related to OPEB by type

14.198 In addition, employers have to present certain 10-year schedules of RSI[20] and related notes as discussed in paragraphs 170–171 of GASB Statement No. 75, including information on the changes in the employer's total OPEB liability and key ratios.

Special Funding Situations

14.199 For OPEB plans that are not administered through a qualifying trust, GASB Statement No. 75 defines *special funding situations* as circumstances in which a nonemployer entity is legally responsible for making benefit payments directly as the OPEB comes due to the employees of another entity or entities and either (*a*) the amount of benefit payments for which the nonemployer entity is legally responsible is not dependent upon one or more events unrelated to OPEB, or (*b*) the nonemployer is the only entity with a legal obligation to make benefit payments directly to the employees.

14.200 An employer that has a special funding situation for defined benefit OPEB is required to recognize an OPEB liability and deferred outflows of resources and deferred inflows of resources related to OPEB with adjustments for the involvement of nonemployer contributing entities. The employer is required to recognize its proportionate share of the collective, as well as additional OPEB expense and revenue related to the expense recognized by the nonemployer contributing entities. The employer is also required to disclose in the notes to the financial statements information about the amount of support

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[20] See footnote 6.

provided by nonemployer contributing entities and present similar information about the involvement of those entities in 10-year schedules of RSI. See paragraphs 193–202 of GASB Statement 75 for specific accounting related to special funding situations.

14.201 The recognition and measurement of liabilities, deferred outflows of resources, deferred inflows of resources, and expense by a governmental nonemployer contributing entity in a special funding situation for defined benefit OPEB is similar to that of cost-sharing employers discussed in part III. See paragraphs 203–221 of GASB Statement No. 75 for specific accounting and disclosure requirements related to special funding situations for nonemployer contributing entities.

Auditing Considerations for Employers When the Plan Is Not Administered Through a Qualifying Trust

14.202 This section discusses considerations, including describing the relevant assertions, when auditing the OPEB information included in the employer's financial statements. This section does not include all risks or all procedures that could apply to such audits in accordance with generally accepted auditing standards; instead, it focuses on specific considerations for testing certain financial statement elements of the employer's financial statements affected by defined benefit OPEB plans, including total OPEB liability, deferred outflows of resources, deferred inflows of resources, and OPEB expense. The example substantive audit procedures are not considered required procedures, nor are they all-inclusive.

Determining Audit Strategy

14.203 Determining the audit strategy for the OPEB information in the employer's financial statements requires the auditor to understand what activities the various parties perform. Example activities include maintaining records, determining OPEB liabilities, disbursing benefits (premiums and claims payments), and paying expenses. OPEB plans that are not administered through a qualifying trust are usually administered under the governance structure of the employer. Activities of the plan may be performed by the employer's personnel or outsourced to a third party.

14.204 Understanding the provisions and key elements of the substantive plan (for example, eligibility, contributions, vesting, and benefit payments) is necessary for the auditor to design an appropriate audit strategy. See the emphasis point after paragraph 14.49 that discusses how to determine what constitutes the provisions of the substantive plan.

14.205 The auditor uses the understanding of the nature of the activity, as well as the party responsible for each activity, to understand what can go wrong to identify and assess the risks of material misstatement surrounding those activities in order to determine the nature, timing, and extent of audit procedures. (See chapter 4 of this guide for a discussion of the auditor's risk assessment and response to assessed risks.)

14.206 When activities are performed by the employer or through a third-party administrator, controls responsive to the risks tested may help to reduce the extent of substantive procedures if those controls are operating effectively.

Census Data

14.207 As discussed in paragraphs 14.14–.16, certain financial statement elements of employers that participate in defined benefit OPEB plans (that is, total OPEB liability, deferred outflows of resources, deferred inflows of resources, and OPEB expense) are dependent on members' demographic data (census data). The employer auditor's consideration of the relevant financial statement assertions that are dependent on census data begins with understanding the processes and internal control used by the employer to support the completeness and accuracy of significant elements of census data that are provided to the actuary.

14.208 *Significant elements of census data* include those elements that, either individually or when combined with other elements, could result in a material misstatement to one or more elements of the employer's financial statements (that is, total OPEB liability, deferred outflows of resources, deferred inflows of resources, and OPEB expense). Significant elements of census data may include some or all of the following:

- *a.* Name
- *b.* Social Security number
- *c.* Date of birth
- *d.* Date of hire
- *e.* Marital status
- *f.* Dependents
- *g.* Service credits (periods of time worked)
- *h.* Class of employee
- *i.* Position or job code (or both)
- *j.* Gender
- *k.* Date of termination or retirement
- *l.* Spouse's date of birth
- *m.* Employment status (active, inactive entitled to but not receiving benefits, retired)

The significance of some of these elements, all of these elements, or additional elements to any plan will be based on the impact that a particular census data element has on the measurement of a particular financial statement element.

> ***Emphasis Point***
>
> Many OPEB plans allow members to choose from more than one health care plan option through an annual open enrollment process (for example, an HMO, PPO, or traditional indemnity plan). Although the benefits election is not an element of census data, such elections are considered in the utilization assumptions by the actuary in projecting benefit (claims) costs in the actuarial valuation.

14.209 The substantive procedures over census data at the employer are ordinarily based on a concept that focuses on testing incremental changes to the census data file since the prior actuarial valuation, assuming (*a*) the prior year financial statements were audited, (*b*) there were no modifications to the auditor's report in the prior year related to census data, and (*c*) the auditor has concluded there is no significant risk of material misstatement due to incomplete or inaccurate census data from prior years. These procedures would ordinarily cover the census data changes during 1) the year immediately preceding the actuarial valuation when the actuarial valuation is performed on an annual basis, or 2) the two-year period immediately preceding the actuarial valuation when the actuarial valuation is performed on a biennial basis.

Special Funding Situations

14.210 Some plans include *special funding situations*, which are situations when a nonemployer entity is legally responsible for making benefit payments directly as the OPEB comes due for benefits provided through such a plan that is used to provide OPEB to the employees of another entity or entities. The audit guidance in this chapter does not address special funding situations. If such a situation exists, the employer auditor should perform appropriate audit procedures.

14.211 GASB Statement No. 75 provides specific criteria to be considered a special funding situation. Careful evaluation of the employer's documentation to substantiate whether there is, or is not, a special funding situation is necessary. Such documentation may need to include a legal opinion if the relevant statutes or substantive plan document are not specifically based on the criteria in GASB Statement No. 75. For financial reporting purposes, such legal opinion should be based on the criteria for a special funding situation in GASB Statement No. 75, as opposed to a legal notion of liability or obligation.

Total OPEB Liability, Deferred Outflows of Resources, Deferred Inflows of Resources, and OPEB Expense

14.212 In addition to the discussion in chapter 4 of this guide related to the auditor's risk assessment and understanding of the entity, auditor considerations specific to total OPEB liability, deferred outflows of resources, deferred inflows of resources, and OPEB expense include obtaining an understanding of the actuary's objectives, scope of work, methods and assumptions, and consistency of application.

Relevant Assertions

14.213 The relevant assertions related to total OPEB liability, deferred outflows of resources, deferred inflows of resources, and OPEB expense include the following:

a. Member census data used in calculating the actuarially computed total OPEB liability is complete and accurate.

b. Actuarial assumptions used in computing the total OPEB liability are in accordance with GASB Statement No. 75 requirements and the Actuarial Standards of Practice.

c. The employer OPEB amounts, including total OPEB liability, deferred outflows of resources, deferred inflows of resources, and OPEB expense have been properly calculated and reported in the financial statements in accordance with GASB Statement No. 75 and in the proper period and are properly disclosed.

Examples of Identified Risks of What Can Go Wrong at the Relevant Assertion Level

14.214 The following are examples of identified risks of what can go wrong at the relevant assertion level related to total OPEB liability, deferred outflows of resources, deferred inflows of resources, and OPEB expense:

Total OPEB Liability

a. The actuary does not have the appropriate qualifications or related experience to perform the valuation.

b. Members are inappropriately excluded from, or included in, the census data.

c. Census data does not reconcile to (agree with) the employer's payroll and personnel records, causing errors in the computation of total OPEB liability.

d. Census data is not properly accumulated (maintained) for active members as well as activity for inactive members, causing errors in the computation of total OPEB liability.

e. The actuary uses incomplete (missing) or incorrect census data, causing errors in the computation of total OPEB liability.

f. The actuary uses inappropriate assumptions or actuarial methods that are not in conformity with GASB Statement No. 75 and the Actuarial Standards of Practice, causing errors in the computation of total OPEB liability. Examples of inappropriate assumptions or actuarial methods include the following:

   i. Using an actuarial cost method other than entry age normal for computing the total OPEB liability

   ii. Using a health care trend rate that does not reflect the future expected increases in per capita health claims rates over time due to factors such as medical inflation, utilization, plan design, and technology improvements

   iii. Using a cost change rate that does not reflect the future expected increases of other costs such as the cost of life insurance and long-term care insurance

   iv. Not properly considering current and future participation rates of members in projection of benefits

Emphasis Point

For plans that require some form of payment from inactive members receiving benefits to maintain coverage, some eligible individuals may elect not to be covered, particularly if they have other coverage available. In accordance with Actuarial Standard of Practice No. 6, empirical data on plan participation, where available and credible, should be considered when selecting the participation assumption for future retirees. When developing the participation rates, the actuary should consider how plan eligibility rules, plan choices, or retiree contribution rates have changed over time.

Furthermore, plan participation may be different in the future due to participants' response to changes in retiree contribution levels and plan choices (for example, Medicare+Choice). For plans that anticipate changes in retiree contributions, the actuary should consider the appropriateness of participation rates that vary over the projection period for both current and future retirees. The actuary should consider plan eligibility rules governing dropping coverage and subsequent reenrollment when selecting participation rates.

v. Using mortality assumptions that do not properly reflect expected future improvement in mortality rates

g. Projected benefit payments used in the actuarial valuation do not include all benefits to be provided to plan members in accordance with the benefit terms that are in force at the measurement date, causing the inaccurate computation of the total OPEB liability.

h. Projected benefit payments used in the actuarial valuation do not include the effects of automatic postemployment benefit changes, ad hoc benefit changes that are substantively automatic, or projected salary changes, causing the inaccurate computation of the total OPEB liability.

i. Projected benefit payments used in the actuarial valuation do not include taxes or other assessments expected to be imposed on benefit payments, causing the incorrect computation of the total OPEB liability.

j. Projected benefit payments are not based on claims costs, or age-adjusted premiums approximating claims costs, causing the incorrect computation of the total OPEB liability.

k. Plan amendments or changes in benefit terms have not been properly included or excluded as of the measurement date. See the emphasis point on substantive plans after paragraph 14.49.

Deferred Outflows of Resources and Deferred Inflows of Resources

l. Deferred outflows of resources and deferred inflows of resources are not properly calculated and reported in accordance with GASB Statement No. 75.

m. Changes in benefit terms have been incorrectly reported as deferred outflows of resources or deferred inflows of resources.

n. The amortization period used to recognize (amortize) deferred outflows of resources and deferred inflows of resources for each respective year's incremental deferrals has not been properly calculated in accordance with GASB Statement No. 75. For example, the plan incorrectly calculates the amortization period for changes in assumptions based on the average remaining service lives of active employees, instead of the average remaining service lives of all employees (that is, active and inactive plan members).

o. Benefit payments made and administrative costs incurred subsequent to the measurement date are not recognized as a deferred outflow of resources.

OPEB Expense

p. OPEB expense is not properly calculated and reported in accordance with GASB Statement No. 75.

q. Benefit payments are directly considered in OPEB expense.

r. OPEB expense does not properly reflect the impact of service cost (addition) based on the actuarial valuation used to measure total OPEB liability.

s. OPEB expense does not properly reflect the interest on the total OPEB liability.

t. OPEB expense does not include the appropriate amount for the recognition (amortization) of deferred outflows of resources and deferred inflows of resources.

u. OPEB expense does not include changes in benefit terms.

Example Audit Procedures to Consider

Total OPEB Liability

14.215 The following are examples of substantive procedures for auditing the total OPEB liability (excluding census data):

a. Obtaining the actuarial valuation report used to measure the total OPEB liability as of the measurement date based on GASB Statement No. 75

b. Evaluating the professional qualifications of the actuary, including his or her competence, capabilities, and objectivity as required by paragraph .08 of AU-C section 500 (If the actuary is not known to the auditor, consider other factors that might provide information regarding the actuary's qualifications, such as [i] the actuary's membership in a recognized professional organization, [ii] the number and types of OPEB plans served, including years of experience, and [iii] the opinion of other actuaries whom the auditor knows to be qualified regarding the actuary's professional qualifications.)

> ***Emphasis Point***
>
> Paragraph .12 of AU-C section 300 states the auditor should consider whether specialized skills are needed in performing an audit. Consideration of the engagement team's skills, knowledge, and experience as they relate to understanding actuarial information is critical in such engagements. If specialized skills are needed, consider using an auditor specialist (for example, an actuary) in evaluating the appropriateness of the actuarial valuation and the measurement of the total OPEB liability.

c. Inquiring about the nature of any interests or relationships the actuary may have with the plan or employer(s) that may create threats to the actuary's objectivity (for example, financial interests, business or personal relationships, or the provision of other services) and any applicable safeguards

> ***Emphasis Point***
>
> Although safeguards cannot eliminate all threats to the objectivity of an actuary, threats such as intimidation by management may be of less significance to a specialist engaged versus employed by the plan or plan administrator,

and the effectiveness of safeguards such as quality control procedures may be greater. This evaluation of objectivity may be accomplished by the auditor asking management to have the actuary describe in writing interests and relationships, if any, that may exist and that may appear to impair the objectivity of the actuary.

d. Reading the actuarial certification for potential exclusions from the scope of the actuary's work or qualifications on the actuary's certification relating to actuarial methods, actuarial assumptions, or census data

e. Inquiring of management or the actuary whether the actuarial valuation considers all pertinent provisions of the plan, including any changes or amendments to the plan or other events affecting the actuarial calculations that are effective as of the measurement date (See the emphasis point after paragraph 14.49 regarding what should be considered in determining the substantive plan.)

Emphasis Point

Other considerations include whether the valuation includes or does not include the impact of the Medicare subsidy provided by the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 as well as taxes and other assessments.

f. Determining whether the actuarial valuation was performed as of a date no more than 30 months and 1 day from the employer's fiscal year-end

g. Evaluating whether the methods and assumptions used in determining the total OPEB liability are in accordance with GASB Statement No. 75 and Actuarial Standards of Practice (See examples of identified risks of what can go wrong related to actuarial assumptions in paragraph 14.214*f*.)

h. If the actuarial valuation was performed as of a date prior to the measurement date, reviewing the appropriateness of the update procedures to roll forward the total OPEB liability to the measurement date and determining whether all significant known events occurring between the valuation date and the measurement date have been properly included

i. Testing the reliability and completeness of the member census data used (See paragraphs 14.207–.209 for specific procedures.)

j. Evaluating whether the projected benefit payments were properly discounted using an appropriate 20-year AA municipal bond yield or index rate as of the measurement date

Census Data

14.216 The following are examples of substantive procedures when auditing census data used in the measure of total OPEB liability:

Emphasis Point

As discussed in paragraph 14.209, the substantive procedures over census data are ordinarily based on a concept that focuses on testing incremental changes to the census data file during 1) the year immediately preceding the actuarial valuation date when actuarial valuations are performed on an annual basis, or 2) the two-year period immediately preceding the actuarial valuation when the actuarial valuations are performed on a biennial basis. These procedures would ordinarily cover the incremental census data accumulated by the employer (that is, changes to the census data file) during the applicable period. For example, if an employer has a fiscal year-end of June 30, 20X7, and uses a beginning of the year actuarial valuation as of July 1, 20X6 (which is rolled forward to the employer's measurement date of June 30, 20X7), and actuarial valuations are performed on an annual basis, the focus of the procedures would ordinarily be over the incremental changes to the census data during the year ended June 30, 20X6. Additionally, the procedures should cover the entire year and not be limited to a specific point in time during the year.

If the employer performs biennial valuations, the census data to be tested for the July 1, 20X6, valuation would be incremental changes since the last valuation (that is, the two-year period ending June 30, 20X6).

a. Reviewing the actuarial certification (in the actuarial valuation report) to determine whether there were any exceptions identified related to the census data and testing resolution as necessary

b. Obtaining the census data file sent to the actuary from either the actuary or the employer (if obtained from the employer, obtaining evidence that information obtained from the employer was the same information reported to and used by the actuary—for example, obtaining a written confirmation from the actuary)

c. Confirming with the actuary whether there was any missing information or changes made to the census data file provided by employer management

d. Evaluating the potential impact of assumptions used by the actuary in changing census data (for example, corrections to address missing data) on the total OPEB liability

e. Obtaining and testing a reconciliation of aggregate census data to the actuarial valuation report (for example, the number of members reported in the census data file to amounts shown in the actuarial valuation report)

f. Obtaining and testing a roll forward of the census data from the prior valuation to the current valuation, including testing significant reconciling items

g. Comparing the number of plan members for the current year versus the prior year, as well as the number of plan members versus the number of employees (Consider disaggregating the analysis in various ways—for example, by age of employee and status [active employees, inactive employees entitled to but not yet receiving benefits, or inactive employees or their beneficiaries receiving benefits].)

h. Obtaining a list of new employees hired during the period from the prior valuation to the current valuation from the employer and performing the following procedures:

i. Selecting a sample to determine that eligible new employees were appropriately enrolled in the plan and properly included in the census data file

ii. For each employee selected, verifying the accuracy of significant elements of census data from enrollment that are in the census data file to the human resources (personnel) records (for example, name, Social Security number, date of birth, gender, date of hire, marital status, and position or job code)

i. Identifying the payroll registers and payroll cycles for all reporting units of the government

j. Selecting a sample of active members and performing the following procedures:

Emphasis Point

Consider selecting a sample of active members from the employer's payroll registers throughout the year and a sample from the census data file.

i. Evaluating whether the employee is eligible to participate in the plan based on the eligibility criteria included in the plan document (state statutes)

ii. Comparing the static census data (for example, name, date of birth, date of hire, gender, and spouse's date of birth) in the current census data file to the prior census data file

iii. For significant elements of census data that change based on current-year events and activity (for example, service credits and marital status), verifying the incremental changes to the personnel records and recalculating the census data in the current census data file based on the prior census data file and the incremental changes for the period

k. Selecting a sample of inactive members entitled to but not yet receiving benefits and comparing the census data information from the current census data file to the prior census data file (or vice versa)

Emphasis Point

Consider selecting a sample of inactive members entitled to but not yet receiving benefits from the current census data file and a sample from prior census data file.

l. Selecting a sample of inactive members currently receiving benefits and performing the following procedures:

> ***Emphasis Point***
>
> Consider selecting a sample of inactive members currently receiving benefits from the current census data file and a sample from the prior census data file.

i. Comparing the static census data information from the current census data file to the prior census data file
ii. Verifying or recalculating the significant elements of census data that change based on criteria in the plan document

Deferred Outflows of Resources and Deferred Inflows of Resources

14.217 The following are examples of substantive procedures for auditing deferred outflows of resources and deferred inflows of resources:

a. Obtaining a detailed schedule of deferred outflows of resources and deferred inflows of resources by type and period for the employer and performing the following:
   i. Agreeing recognition (amortization) schedules and recognition (amortization) periods for prior period deferral amounts to prior year working papers and audited financial statements, if applicable
   ii. Recalculating the current year gross incremental deferrals for differences between actual and expected experience and changes in assumptions based on information in the actuarial valuation report used to measure the net OPEB liability
   iii. Recalculating the recognition (amortization) amount for the current period incremental deferrals for differences between actual and expected experience and changes in assumptions by dividing the gross incremental deferrals by the current year amortization period
   iv. Verifying benefit payments made and administrative cost incurred after the measurement date and before the employer's year-end and comparing to the amount reported as deferred outflows of resources
   v. Recalculating the mathematical accuracy of the total deferred outflows of resources and deferred inflows of resources by type as of the measurement date and the total recognition (amortization) for measurement period based on the components tested in the procedures described in items *a*(i)–(iv)

> ***Emphasis Point***
>
> If OPEB amounts are allocated between the primary government and component units or to proprietary and fiduciary funds using an allocation methodology similar to employers participating in a cost-sharing plan, there may be two additional types of deferrals related to (*a*) changes in proportion and (*b*) differences between actual OPEB payments and proportionate share of total OPEB payments (see exhibit 14-5). Paragraph 14.186*k* provides suggested procedures on employer-specific deferred outflows of resources and deferred

inflows of resources specific to cost-sharing employers that may be adapted for this purpose.

OPEB Expense

14.218 The following are examples of substantive procedures for auditing OPEB expense:

a. Obtaining a detailed schedule of OPEB expense for the measurement period

b. Comparing total service cost to the actuarial valuation used to measure the total OPEB liability

c. Recalculating interest on total OPEB liability by multiplying beginning total OPEB liability, adjusted for service cost and actual benefit payments, by the discount rate

d. Verifying changes in benefit terms to the actuarial valuation report and procedures performed related to the total OPEB liability in paragraph 14.215

e. Verifying employer administrative costs related to OPEB including the total of nonemployer contributing entities' expenses for costs incurred related to the administration of OPEB, if applicable

f. Reconciling amounts of deferred outflows of resources and deferred inflows of resources recognized as OPEB expense based on procedures performed in paragraph 14.217

g. Recalculating the mathematical accuracy of total OPEB expense based on the individual components

Chapter 15

Concluding the Audit[1]

Introduction

15.01 This chapter addresses procedures that are performed at or near the date of the auditor's report. Those procedures that are performed before the issuance of the auditor's report include (*a*) evaluating misstatements and addressing audit adjustments, (*b*) communication with the government's legal counsel, (*c*) obtaining written representations from management, (*d*) evaluating related-party disclosures, (*e*) considering going concern considerations, (*f*) considering subsequent events, (*g*) performing analytical procedures, (*h*) communicating with those charged with governance, and (*i*) audit documentation.

Misstatements and Audit Adjustments

15.02 The auditor should evaluate the effect of individual and aggregate misstatements in the context of individual opinion units. This is necessary because the auditor's report on the basic financial statements will provide separate opinions on each opinion unit. Also, professional standards concerning misstatements (such as management's representation concluding that uncorrected misstatements are immaterial and the auditor's communication to the audit committee about uncorrected misstatements) should be applied based on opinion units. (See the discussion of the concept of opinion units in planning, performing, and reporting on governmental audits in chapter 4, "General Auditing Considerations," and chapter 16, "Audit Reporting.")

15.03 AU-C section 450, *Evaluation of Misstatements Identified During the Audit* (AICPA, *Professional Standards*), addresses the auditor's responsibility to evaluate the effect of identified misstatements on the audit and the effect of uncorrected misstatements, if any, on the financial statements. AU-C section 450 states that auditors should accumulate misstatements identified during the audit, other than those that are clearly trivial and should communicate misstatements to management on a timely basis. In evaluating misstatements, the auditor should consider the effects, both individually and in the aggregate, of misstatements (known and likely) that are not corrected by the entity. This consideration includes any misstatements that remain uncorrected from different entity locations or that are communicated by the component auditors. In making this evaluation, in relation to particular classes of transactions, account balances, and disclosures, the auditor should consider the size and nature of the misstatements and the particular circumstances of their occurrence, and determine the effect of such misstatements on the financial statements as a whole, which, in the context of a governmental audit, would be by opinion unit, as discussed in paragraph 4.73–.77 of this guide.

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[1] Although the focus of this chapter is on concluding the financial statement audit, significant information is discussed that is the responsibility of management (for example, related party transactions, going concern considerations, and subsequent events) under GASB Statement No. 56, *Codification of Accounting and Financial Reporting Guidance Contained in the AICPA Statements on Auditing Standards*, as amended. These accounting and financial reporting requirements are included here because they have not been discussed elsewhere in this guide.

15.04 As discussed in chapter 4, judgments about materiality include both quantitative and qualitative information. As a result of the interaction of quantitative and qualitative considerations in materiality judgments, misstatements of relatively small amounts that come to the auditor's attention could have a material effect on the financial statements. Qualitative considerations also influence the auditor in reaching a conclusion about whether misstatements are material. Qualitative factors that the auditor may consider relevant to his or her consideration for an affected opinion unit include the following:

- The potential effect of the misstatement on trends, for example, in revenue
- The effect of the misstatement on segment information
- The effect of the misstatement on quantitative materiality if quantitative materiality were calculated without reference to certain individual, large-dollar accounts, such as capital assets and long-term debt
- Misstatements that arise from estimates, allocations, or uncertainties
- The potential effect of the misstatement on the government's compliance with legal and contractual provisions, such as revenue misstatements that might affect the entity's compliance with debt covenants or expenses or expenditures improperly charged to grants that might create a decrease in assets or increase in liabilities (for the amount that the grantor is expected to cancel or reclaim)
- Expenses or expenditures improperly charged to a department, division, or the like that would have created an overbudget situation if charged to the appropriate department, division, or the like
- A misstatement that has the effect of increasing management's compensation, for example by satisfying requirements for the award of bonuses or other forms of incentive compensation
- A miscalculation of valuation(s) or misapplication of a valuation methodology (for example, one that results in a derivative transaction classified as an effective hedge when it is not, or no longer, effective)
- The significance of the financial statement element affected by the misstatement
- The effects of misclassifications, for example, misclassification between operating and nonoperating revenues or restricted and unrestricted net position
- The likelihood that a misstatement that is currently quantitatively immaterial may have a material effect in future periods because of, for example, a cumulative effect that builds over several periods
- The risk that possible additional undetected misstatements would affect the auditor's evaluation
- The sensitivity of the circumstances surrounding the misstatement, for example, the implications of misstatements involving fraud, possible noncompliance with laws and regulations, or conflicts of interest

- The motivation of management with respect to the misstatement, for example, (*a*) an indication of a possible pattern of bias by management when developing and accumulating accounting estimates or (*b*) a misstatement precipitated by management's continued unwillingness to correct weaknesses in the financial reporting process
- The significance of the misstatement or disclosures relative to politically sensitive matters or known user needs

Furthermore, issues such as public interest, accountability, integrity, and ensuring effective legislative oversight, in particular, may affect the assessment of whether an item is material by virtue of its nature. This is particularly so for items that relate to compliance with laws or regulations.

15.05 Information essential for a fair presentation in accordance with generally accepted accounting principles (GAAP) includes information required to be disclosed in the notes to the financial statements. Misstatements that cause the financial statements not to be in accordance with GAAP include the omission of required financial statement disclosures and financial statement disclosures that are not presented in accordance with GAAP. The auditor should evaluate the adequacy and understandability of the note disclosures that accompany the basic financial statements in relation to the fair presentation of each affected opinion unit. That evaluation may require the auditor to exercise professional judgment to determine the opinion units affected by specific disclosures and disclosure requirements. If a particular disclosure requirement is limited to a particular reporting unit or financial statement that is the context within which it should be evaluated. For example, certain disclosures about capital asset balances and activity are required for capital assets of the primary government reported in the government-wide statement of net position. Thus, those disclosures would relate only to governmental activities and business-type activities if those opinion units have capital assets that are or should be reported. Other broader disclosures may relate to all opinion units in the basic financial statements. Examples of such required broad disclosures include, but are not limited to, the following:

- GASB Statement No. 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements*, as amended by GASB Statement No. 40, *Deposit and Investment Risk Disclosures—an amendment of GASB Statement No. 3*, about deposits and investments
- GASB Statement No. 56, *Codification of Accounting and Financial Reporting Guidance Contained in the AICPA Statements on Auditing Standards*, as amended, about related party transactions, going concern considerations,[2] and subsequent events
- GASB Statement No. 68, *Accounting and Financial Reporting for Pensions—an amendment of GASB Statement No. 27*, as amended, about the employer's required contribution rate to a defined benefit pension plan, may relate to all opinion units in the basic financial statements

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[2] GASB Statement No. 56, as amended, requires management to evaluate going concern at the separate legal entity level.

- GASB Statement No. 72, *Fair Value Measurement and Application*, about fair value measurements, the level of fair value hierarchy, and valuation techniques
- GASB Statement No. 77, *Tax Abatement Disclosures*, about tax abatement agreements entered into by governments

Auditors should evaluate both quantitative and qualitative factors in considering whether omitted or improperly presented note disclosures have a material effect on the affected opinion units.

15.06 The auditor should consider the quantitative determination of major funds after all adjustments and reclassifications are made to the financial statements to determine whether all required major funds are separately displayed in the fund financial statements and have received appropriate audit coverage.[3] Paragraph .14 of AU-C section 580, *Written Representations* (AICPA, *Professional Standards*), states that the auditor should request management to provide written representations about whether it believes the effects of any uncorrected misstatements are immaterial, individually and in the aggregate, to the financial statements as a whole. A summary of such items should be included in, or attached to, the written representation. Paragraph .12 of AU-C section 450 states that the auditor should document a summary of uncorrected misstatements, other than those that are trivial, related to known and likely misstatements and the auditor's conclusion as to whether uncorrected misstatements, individually or in aggregate, do or do not cause the financial statements to be materially misstated, and the basis for that conclusion. (See discussion of communicating with those charged with governance in paragraphs 15.44–.45.) AU-C section 260, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*), establishes standards and provides guidance to an auditor on matters to be communicated with those charged with governance. Paragraph .12 of AU-C section 260 describes significant findings from the audit, including uncorrected misstatements that should be communicated to those charged with governance. In a governmental audit, the provisions of AU-C section 260, AU-C section 450, and AU-C section 580, described earlier in this paragraph, should be applied based on individual opinion units.

Litigation, Claims, and Assessments

15.07 Paragraph .16 of AU-C section 501, *Audit Evidence—Specific Considerations for Selected Items* (AICPA, *Professional Standards*), requires the auditor to design and perform audit procedures to identify litigation, claims, and assessments involving the entity that may give rise to a risk of material misstatement. AU-C section 501 discusses specific procedures for such identification as well as the audit requirements for actual or potential litigation, claims, and assessments identified.

15.08 Unless the audit procedures required by paragraph .16 of AU-C section 501 indicate that no actual or potential litigation, claims, or assessments that may give rise to a risk of material misstatement exist, the auditor should directly communicate with the government entity's legal counsel through a

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[3] As discussed in chapter 2, "Financial Reporting," a government is required to report certain governmental and enterprise funds as major in its fund financial statements based on quantitative criteria. Chapter 16, "Audit Reporting," discusses the effect on the auditor's report if a required major fund is not reported as such. Also see paragraphs 15.10–.14.

letter of inquiry prepared by management. As discussed in AU-C section 501, in the letter of inquiry, the auditor should request legal counsel to inform the auditor of any litigation, claims, assessments, and unasserted claims that counsel is aware of, together with an assessment of the outcome and an estimate of the financial implications, including costs involved. In addition, the auditor should, in cases when the government entity's in-house legal counsel (such as a city attorney or state attorney general) has the responsibility send a similar letter of inquiry. However, audit evidence obtained from in-house counsel is not a substitute for the auditor's direct communication with external legal counsel. Paragraph .A64 of AU-C section 501 provides guidance for direct communication with an entity's in-house legal counsel.

15.09 Occasionally, a government may not retain inside or outside counsel and may not have consulted a lawyer during the period about litigation, claims, or assessments.[4] In those cases, the auditor may consider obtaining representations from management that no lawyers were consulted during the period, perhaps as part of the written representations discussed in paragraphs 15.10–.14. When a lawyer is not consulted, the auditor has to rely on other audit procedures, including inquiries of government officials, and subsequent events procedures described in the following section beginning with paragraph 15.31, to determine whether the government has appropriately reported and disclosed the existence of litigation, claims, and assessments. (See also chapter 8, "Expenses or Expenditures and Liabilities," for a discussion of the accounting, financial reporting, and auditing considerations for claims and judgments and commitments.)

Written Representations

15.10 Paragraph .09 of AU-C section 580 states that the auditor should request written representations from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned. AU-C section 580 includes a list of matters for which specific representations should be made, as well as an illustrative representation letter and an appendix containing additional representations that may be appropriate to include in a representation letter. In addition, AU-C section 725, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*), and AU-C section 730, *Required Supplementary Information* (AICPA, *Professional Standards*), require additional written management representations, when applicable, with respect to supplementary information (SI) and required supplementary information (RSI), respectively. The following are among the types of written representations that an auditor should obtain in a governmental engagement:

- Management has disclosed all instances of identified or suspected noncompliance with laws, regulations, and provisions of contracts and grant agreements whose effects should be considered by management when preparing the financial statements (for example, tax or debt limits and debt covenants). (See the discussion of the GASB requirements for disclosure relating to material violations of finance-related legal and contractual provisions and the

[4] AU-C section 501, *Audit Evidence—Specific Considerations for Selected Items* (AICPA, *Professional Standards*), requires that the auditor should document the basis for any determination not to seek direct communication with the entity's legal counsel.

auditor's responsibility with regard to those disclosure requirements in chapter 4.)

- Management is responsible for the design, implementation, and maintenance of internal controls to prevent and detect fraud; management has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud; management has disclosed its knowledge of fraud or suspected fraud affecting the entity involving management, employees who have significant roles in internal control, and others where the fraud could have a material effect on the financial statements; and management's knowledge of any allegations of fraud or suspected fraud affecting the entity's financial statements.
- Management has indicated whether it believes the effects of the uncorrected financial statement misstatements are immaterial, individually and in the aggregate, to the financial statements as a whole for each opinion unit.
- Management acknowledges (*a*) its responsibility for the RSI; (*b*) that the RSI is measured and presented in accordance with prescribed guidelines; and (*c*) whether the methods of measurement or presentation have changed from those used in the prior period and, if so, the reasons for such changes; and (*d*) any significant assumptions or interpretations underlying the measurement or presentation of RSI.
- Management acknowledges (*a*) its responsibility for the presentation of the SI in accordance with the applicable criteria; (*b*) that it believes the SI, including its form and content, is fairly presented in accordance with applicable criteria; (*c*) that the methods of measurement or presentation have not changed from those used in the prior period or, if the methods of measurement or presentation have changed, the reasons for such changes; (*d*) about any significant assumptions or interpretations underlying the measurement of the SI; and (*e*) that when SI is not presented with the audited financial statements, management will make the audited financial statements readily available to the intended users of the SI and the auditor's report thereon.

15.11 AU-C section 580 also states that in addition to required representations, the auditor may determine that it is necessary to obtain one or more written representations to support other audit evidence relevant to the financial statements for one or more specific assertions in the financial statements. Depending on the circumstances and professional judgment, the auditor of a governmental entity should consider obtaining representations from management that include the following:[5]

- Management has followed applicable laws and regulations in adopting, approving, and amending budgets.

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[5] Chapter 3, "Planning and Performing a Financial Statement Audit in Accordance With *Government Auditing Standards*," and chapter 10, "Compliance Auditing Applicable to Major Programs," of the AICPA Audit Guide Government Auditing Standards *and Single Audits* discuss additional written representations that the auditor should consider obtaining in audits performed under *Government Auditing Standards* and in a single audit

- The financial statements include all component units as well as joint ventures with an equity interest, and properly disclose all other joint ventures and other related organizations.
- The financial statements properly classify all funds and activities in accordance with GASB Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*, as amended.
- All funds that meet the quantitative criteria in GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, as amended, and No. 37, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Omnibus—an amendment of GASB Statements No. 21 and No. 34*, for presentation as major are identified and presented as such and all other funds that are presented as major are particularly important to financial statement users.
- Components of net position (net investment in capital assets, restricted, and unrestricted) and classifications of fund balance (nonspendable, restricted, committed, assigned, and unassigned) are properly classified and, if applicable, approved.
- Investments, derivative transactions, and land and other real estate held by endowments are properly valued.
- Provisions for uncollectible receivables have been properly identified and recorded.
- Expenses have been appropriately classified in or allocated to functions and programs in the statement of activities, and allocations have been made on a reasonable basis.
- Revenues are appropriately classified in the statement of activities within program revenues, general revenues, contributions to term or permanent endowments, or contributions to permanent fund principal.
- Interfund, internal, and intra-entity activity and balances have been appropriately classified and reported.
- Special and extraordinary items are appropriately classified and reported.
- Risk disclosures associated with deposit and investment securities and derivative transactions are presented in accordance with GASB requirements.
- Capital assets, including infrastructure and intangible assets, are properly capitalized, reported, and, if applicable, depreciated.
- If the modified approach is used to account for eligible infrastructure assets, the entity meets the GASB-established requirements for doing so.
- The government's policy regarding whether to first apply restricted or unrestricted resources when an expense is incurred for purposes for which both restricted and unrestricted net position is available and appropriately disclosed and that net position is properly recognized under the policy.
- The government is following either its established accounting policy regarding which resources (that is, restricted, committed, assigned, or unassigned) are considered to be spent first for

expenditures for which more than one resource classification is available or is following paragraph 18 of GASB Statement No. 54 to determine the fund balance classifications for financial reporting purposes.

- The substance of related party transactions has been considered and appropriate adjustments or disclosures are made in the financial statements.
- Subsequent events have been evaluated and classified as recognized or nonrecognized and the date through which this determination was made.
- For any government that has petitioned for relief under Chapter 9 of the U.S. Bankruptcy Code, or has been granted relief under the provisions of Chapter 9, that any assets and liabilities required to be adjusted to amounts confirmed by the court in a Plan of Adjustment and the resulting gain or loss have been appropriately adjusted and disclosed in the financial statements in accordance with GASB Statement No. 58, *Accounting and Financial Reporting for Chapter 9 Bankruptcies*, as amended.
- The entity's ability to continue as a going concern was evaluated and that appropriate disclosures are made in the financial statements as necessary under GASB requirements.
- The government has disclosed the names of all governments with which it has a tax abatement agreement, the total gross amount of taxes abated during the period, the specific taxes that were abated, and whether any commitments other than to reduce taxes were made as part of any tax abatement agreement as required by GASB Statement No. 77.

Written representations in audits of governmental entities are also discussed in paragraphs 15.02, 15.06, and 15.09.

15.12 As indicated in paragraph 15.10, an auditor should obtain representations from those members of management with overall responsibility for financial and operating matters whom the auditor believes are not only responsible for the financial statements, but also knowledgeable about, directly or through others in the organization, the matters covered by the representations. Members of management normally include the chief executive officer and chief financial officer or others in equivalent positions of the primary government, as well as the management of component units and of large or autonomous agencies and departments. Depending on the nature of the representation (such as compliance with laws and regulations), the auditor may consider obtaining letters from other officials covering these specific representations.

15.13 As noted in AU-C section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* (AICPA, *Professional Standards*), the group engagement team should request that a component auditor communicate matters relevant to the group engagement team's conclusion, with regard to the group audit. When the auditor of the group financial statements assumes responsibility for the work of a component audit, there are additional requirements for the component auditor communication as outlined in paragraphs .59–.60 of AU-C section 600. Among those are a requirement for the group auditor to request that the component unit auditor communicate any other matters that might be relevant to the group audit or that the component auditor wishes to draw to the attention of the group engagement team, including exceptions noted in the written representations that the component auditor requested from component management. (Chapter 4 provides a discussion of the requirements applicable to the audits of group financial statements.)

15.14 AU-C section 580 discusses auditors' responsibilities for obtaining written representations in an audit engagement when current management was not present during all periods referred to in the auditor's report. It may be difficult for the auditor to obtain a representation letter if the responsible administrative officer was not in that position during the audit period. For example, a newly elected official may not be willing, or able, to sign representations relating to a period before the beginning of his or her term of office unless that official obtains supporting representations from other key officials who were responsible for financial matters during the audit period. Paragraph .25 of AU-C section 580 indicates that management's refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unmodified opinion and is ordinarily sufficient to cause an auditor to disclaim an opinion or withdraw from the engagement.

Related-Party Transactions

15.15 The primary accounting and auditing focus for related parties is adequate presentation and disclosure in the financial statements. GASB Statement No. 56, as amended, and paragraphs 54–57 of GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, as amended, provide requirements for related party transactions. For financial reporting purposes, if the substance of a particular transaction is significantly different from its form because of the involvement of related parties, the substance of the transaction rather than merely its legal form should be recognized in the financial statements. Examples of transactions with related parties that have features that may indicate that governments should consider whether a form-over-substance condition exists include

- borrowing or lending on an interest-free basis or at a rate of interest significantly above or below market rates prevailing at the time of the transaction.
- selling real estate at a price that differs significantly from its appraised value.
- exchanging property for similar property in a nonmonetary transaction.
- making loans with no scheduled terms for when or how the loans will be repaid.

GASB Statement No. 56, as amended states that determining the substance of a related party transaction may pose challenges not present in assessing transactions between unrelated parties. For example, a related party relationship may result in transactions that would not take place between unrelated parties or would be subject to different terms and conditions. In such cases, the substance of the related party transaction may differ from its legal form due to the related party relationship.[6]

15.16 Further, state and local governments are required to disclose certain related party transactions. National Council on Governmental Accounting Interpretation 6, *Notes to the Financial Statements Disclosure*, as amended, and paragraphs 55–56 of GASB Statement No. 62, as amended, are the sources of these disclosure requirements. In addition, GASB Statement No. 34 paragraph 128 requires disclosure, for each major component unit, of the nature and amount of significant transactions with the primary government and other component units. Disclosures of related party transactions should include the following:

- The nature of the relationship(s) involved
- A description of the transactions, including transactions to which no amount or nominal amounts were ascribed, for each of the periods for which financial statements are presented, and such other information deemed necessary to gain an understanding of the effects of the transactions on the financial statements
- The dollar amounts of transactions for each of the periods for which financial statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period
- Amounts due from or to related parties as of the date of each statement of net position presented and, if not otherwise apparent, the terms and manner of settlement

15.17 AU-C section 550, *Related Parties* (AICPA, *Professional Standards*), addresses the auditor's responsibilities relating to related party relationships and transactions and expands on how AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*, AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, and AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks of Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), are applied in regard to the risk of material misstatement associated with those related party matters. Chapter 4 discusses the need for the auditor to perform procedures to identify related-party transactions during audit planning and provides additional examples of related parties in a governmental audit. Substantive procedures might include testing whether individual items are related-party transactions and whether they are properly disclosed.

15.18 AU-C section 700, *Forming an Opinion and Reporting on Financial Statements* (AICPA, *Professional Standards*), requires the auditor to evaluate whether the financial statements for the opinion units achieve fair presentation. Thus, in forming an opinion on the financial statements of the opinion units, the auditor should evaluate whether the identified related party relations and transactions have been appropriately accounted for and disclosed and

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[6] It may not be possible to determine whether a particular transaction would have taken place if the parties had not been related, or what the terms and conditions would have been. Therefore, it may be difficult to determine whether a transaction was consummated on terms comparable to those that would be present in arm's-length transactions. Furthermore, governments frequently enter into transactions and engage in activities that are driven by societal needs and concern for the public good. Therefore, it may not be appropriate to compare some governmental programs and arrangements to what might have occurred in an arm's-length transaction in the private-sector or with unrelated parties.

whether any such relations and transaction prevent the financial statements from achieving fair presentation.

Going Concern Considerations

Update 15-1 *Going Concern Considerations*

SAS No.132, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, AU-C sec. 570), expands current guidance regarding risk assessment, reporting and auditing considerations related to an entity's ability to continue as a going concern. The standard emphasizes that the responsibility to assess an entity's ability to continue as a going concern lies with management.

The standard provides guidance for periods beyond management's evaluation period and additional audit procedures for when conditions exist that raise substantial doubt about an entity's ability to continue as a going concern.

The standard will supersede the provisions of AU-C section 570A, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*), and amend the provisions of AU-C section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*, and AU-C section 930, *Interim Financial Information* (AICPA, *Professional Standards*) upon its effective date.

The standard is effective for audits of financial statements for periods ending on or after December 15, 2017.

Upon its effective date, the standard will affect the guidance related to the auditor's consideration of going concern and written representations in this chapter.

The full text of the standard is available on the AICPA's website at www.aicpa.org.

15.19 Under GASB Statement No. 56, as amended, governments have a responsibility to evaluate whether there is substantial doubt about their ability to continue as a going concern for 12 months beyond the financial statement date. (These evaluations should not be performed on reporting units that constitute less than a legally separate entity.) If there is information that is currently known to the government that may raise substantial doubt shortly after this 12 month period (for example, within an additional 3 months), it also should be considered. Continuation of a legally separate governmental entity as a going concern is assumed in financial reporting in the absence of significant information to the contrary. Information that may significantly contradict the going concern assumption would relate to the following:

- A governmental entity's inability to continue to meet its obligations as they become due without substantial disposition of assets outside the ordinary course of governmental operations
- Restructuring of debt
- Submission to the oversight of a separate fiscal assistance authority or financial review board, or similar actions

15.20 Indicators that there may be substantial doubt about a governmental entity's ability to continue as a going concern, as stated in GASB Statement No. 56, as amended, include the following:

- *Negative trends.* Recurring periods in which expenses and expenditures significantly exceed revenues, recurring unsubsidized operating losses in business-type activities, consistent working capital deficiencies, continuing negative operating cash flows from business-type activities, or adverse key financial ratios.
- *Other indications of possible financial difficulties.* Default on bonds, loans or similar agreements, proximity to debt and tax limitations, denial of usual trade credit from suppliers, restructuring of debt (other than refundings), noncompliance with statutory capital or reserve requirements, or the need to seek new sources or methods of financing or to dispose of substantial assets.
- *Internal matters.* Work stoppages or other labor difficulties, substantial dependence on the success of a particular project or program, uneconomic long-term commitments (burdensome labor contracts, for example), or the need to significantly revise operations.
- *External matters.* Legal proceedings, legislation, or similar matters that might jeopardize intergovernmental revenues and the fiscal sustainability of key governmental programs; loss of a critical license or patent for a business-type activity; loss of a principal customer, taxpayer, or supplier; or uninsured or underinsured catastrophe such as a drought, earthquake, or flood.

15.21 Additional specific examples of conditions or events that may indicate substantial doubt about a government's ability to continue as a going concern are as follows:

- Continuing significant fund balance or net position deficits, or a pattern of annual operating deficits
- Extremely high estimated liability for actual or incurred-but-not-reported claims for uninsured risks, including large adverse legal decisions or settlements
- Higher anticipated costs on construction and similar long-term projects than the entity can reasonably finance given current economic conditions
- Burdensome pension plan or postemployment benefit obligations other than pensions combined with diminishing revenues
- Potential for large tax refunds because of, for example, taxpayers' challenges
- Declining tax or other revenue base because of, for example, property value reassessments, competitive changes (such as consumer choice for electric utility services), or a recessionary economy
- Unwillingness of government officials to pay legally incurred liabilities
- Unwillingness of other governments to continue funding programs at existing levels
- Large investment losses

- Bond rating lowered below investment grade
- Debt covenant violations
- Excessive use of short-term borrowing to reduce cash shortages, including tax and revenue anticipation notes
- Long-term borrowing to eliminate deficits or to meet current operating needs
- Increased borrowings from component units that are not expected to be repaid within a reasonable period of time

15.22 In all cases, GASB Statement No. 56, as amended, states that the effect of the governmental environment should be considered when evaluating the indicators. For example, the taxing power and borrowing capabilities of governments together with the constant demand for the provision of public services are factors that may diminish the possibility that a government would be unable to continue as a going concern. GASB Statement No. 56, as amended, also states that some conditions or situations identified in the indicators in paragraph 15.20 should be assessed differently for governments. For example, recurring operating losses are commonplace for some business-type activities such as transit operations or governmental health care organizations. However, quality-of-life considerations and the health and welfare needs and interests of the citizenry may create compelling incentives for those operations to be subsidized to the extent necessary by another governmental entity.

15.23 GASB Statement No. 56, as amended, identifies several required note disclosures if a government determines there is substantial doubt about its ability to continue as a going concern. The notes to the financial statements should include disclosure of the following, as appropriate:

- Pertinent conditions and events giving rise to the assessment of substantial doubt about the government's ability to continue as a going concern for a reasonable period of time
- Possible effects of such conditions and events
- Government officials' evaluation of the significance of those conditions and events and any mitigating factors
- Possible discontinuance of operations
- Government officials' plans (including relevant prospective financial information)
- Information about the recoverability or classification of recorded asset amounts or the amounts or classification of liabilities

In addition, GASB Statement No. 34 paragraph 11(h), as amended, requires a discussion in management's discussion and analysis (MD&A) of currently known facts, decisions, or conditions that are expected to have a significant effect on the government's financial position or results of operations. It may be necessary to include a discussion of going concern issues in the MD&A, depending on the facts and circumstances.

15.24 Although rare, some governments have declared bankruptcy. GASB Statement No. 58, as amended, provides accounting and reporting guidance for governments that have petitioned for protection from creditors by filing for bankruptcy under Chapter 9 of the United States Bankruptcy Code. GASB Statement No. 58, as amended, requires governments to remeasure liabilities based on the terms specified in the Plan of Adjustment confirmed by the court.

For a government that is not expected to emerge from bankruptcy as a going concern, the statement requires remeasurement of its assets to the value that represents the amount expected to be received as of the date of the confirmation of the Plan of Adjustment. Any gains or losses resulting from remeasurement are required to be reported as extraordinary items and any costs directly related to the bankruptcy proceedings are required to be reported as an expense or expenditure when incurred. A number of disclosures related to the conditions or events giving rise to the bankruptcy, their expected or known effects and the significance of such conditions or events on levels of service and operations are required to be disclosed for governments that have filed for bankruptcy. Additional disclosures are required related to the possible termination of the government and how a copy of the Plan of Adjustment may be obtained.

15.25 As stated in AU-C section 570A, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*), the auditor has a responsibility to evaluate the government's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited.[7] The auditor's evaluation is based on the auditor's knowledge of relevant conditions or events that exist at, or have occurred prior to, the date of the auditor's report. Information about such conditions or events is obtained from the application of auditing procedures planned and performed to achieve audit objectives that are related to management's assertions embodied in the financial statements being audited, including assertions required by GASB Statement No. 56. AU-C section 570A provides guidance to the auditor on (*a*) the adequacy of financial statement disclosure, (*b*) the need to modify the auditor's report, and (*c*) audit documentation concerning the auditor's going concern evaluation. Additionally, AU-C section 570A states that, ordinarily, information that significantly contradicts the going concern assumption relates to the entity's inability to continue to meet its obligations as they become due without substantial disposition of assets outside the ordinary course of business, restructuring of debt, externally forced revisions of its operations, or similar actions.

15.26 AU-C section 570A also indicates that if, after considering the identified conditions and events in the aggregate, the auditor believes there is substantial doubt about the ability of the entity to continue as a going concern for a reasonable period of time, the auditor should obtain information about management's plans that are intended to mitigate the adverse effects of the conditions and events. The auditor should assess whether it is likely that the adverse effects will be mitigated for a reasonable period of time and that such plans can be effectively implemented. The auditor should identify those elements of management's plans that are particularly significant to overcoming the adverse effects of the conditions or events and plan and perform procedures to obtain audit evidence about them, including, when applicable, considering the adequacy of support regarding the ability to obtain additional financing or the planned disposal of assets. Additionally, the auditor should evaluate whether the government entity's going concern assessment complies with the requirements of GASB Statement No. 56, as amended, and then evaluate whether it provides additional appropriate evidence regarding management's going concern assertion.

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[7] GASB Statement No. 56, as amended, requires a government to consider information currently known to them that may raise substantial doubt shortly after such 12 month period (for example, an additional 3 months).

15.27 In a governmental audit, the auditor also should consider whether other governments have a legal or moral responsibility to subsidize or otherwise provide financial support to the government being audited. Those subsidies could affect the auditor's evaluation of the likelihood that the government being audited might, for example, default on debt or be unable to meet pension costs or other obligations, support activities that are incurring large deficits, or support present operating levels.

15.28 The auditor should evaluate whether conditions or events that indicate there could be substantial doubt about the government's ability to continue as a going concern, such as those described previously, were noted during the audit up to the date of the auditor's report. In addition to standard audit procedures that may identify such conditions and events, procedures that are unique or significant in government may include the following:

- Reviewing compliance with the terms of debt, loan, and grant agreements
- Reading minutes of meetings of the governing board or any other administrative board with management oversight
- Confirming with related and third parties the details of arrangements to provide or maintain financial support
- Reviewing correspondence from rating agencies for any adverse downgrade of the entity's overall credit rating or that of any specific bond issue

15.29 See AU-C section 570A for additional guidance on the effect of the auditor's consideration of going concern on the financial statements, the notes to the financial statements, the auditor's report, and audit documentation.

15.30 There may be circumstances in which a governmental entity has disclosed certain condition(s) or event(s) in the financial statements (such as fund balance or net position deficits, violations of debt covenants, or default on bonds) that are indicators of substantial doubt of the government's ability to continue as a going concern, but collectively the indicator(s) do not meet the criteria for a going concern under GASB Statement No. 56, as amended. However, these indicator(s) could significantly curtail the government's ability to continue providing public services at the current level. Paragraph .05 of AU-C section 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report* (AICPA, *Professional Standards*), provides that an emphasis-of-matter paragraph may be included in the auditor's report, at the auditor's discretion, that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's professional judgment, is of such importance that it is fundamental to users' understanding of the financial statements. Depending on the facts and circumstances, when the government does not meet the criteria for a going concern but the indicators could significantly curtail the government's ability to continue providing public services at the current level, an emphasis-of-matter paragraph may assist those users in understanding the financial position of the government entity.

Subsequent Events

15.31 GASB Statement No. 56, as amended, requires governments to evaluate and report subsequent events. *Subsequent events* are defined in GASB Statement No. 56, as amended, as those events or transactions that occur subsequent to the statement of net position date but before the financial statements are issued. Some of those events and transactions (referred to as *recognized events*) require adjustments to the financial statements, and others (referred to as *nonrecognized events*) may require disclosure in the notes to the financial statements.

15.32 GASB Statement No. 56, as amended, defines *recognized events* as those events that provide additional evidence with respect to conditions that existed at the date of the statement of net position and affect the estimates inherent in the process of preparing financial statements. All information that becomes available prior to the issuance of the financial statements should be used in evaluating the conditions on which the estimates were based. The financial statements should be adjusted for any changes in estimates resulting from the use of such evidence.

15.33 GASB Statement No. 56, as amended, defines *nonrecognized events* as those events that provide evidence with respect to conditions that did not exist at the date of the statement of net position but arose subsequent to that date. Some of these events, however, may be of such a nature that their disclosure is essential to a user's understanding of the financial statements.

15.34 GASB Statement No. 56, as amended, states that identifying recognized events that require adjustment of the financial statements calls for the exercise of professional judgment. Subsequent events affecting the realization of assets such as receivables and inventories or the settlement of estimated liabilities will ordinarily require adjustment of the financial statements (recognized event) because such events typically represent the culmination of conditions that existed over a relatively long period of time.

15.35 GASB Statement No. 56, as amended, also states that subsequent events such as changes in the quoted market prices of securities ordinarily should not result in adjustment of the financial statements because such changes typically reflect a concurrent evaluation of new conditions. Other examples of nonrecognized events cited in GASB Statement No. 56, as amended that require disclosure in the notes to the financial statements include the issuance of bonds, the creation of a new component unit, or loss of a government facility as a result of a tornado, fire, or flood.[8]

15.36 GASB Statement No. 56, as amended, acknowledges that when financial statements are reissued, certain events may have occurred subsequent to the original issuance that require disclosure. Events requiring disclosure are those considered essential to a user's understanding of the reissued financial statements. These events, occurring between the original issuance of the financial statements and the reissuance of the financial statements, should not result in adjustment of the financial statements unless the adjustment meets the criteria for the correction of an error or the criteria for prior-period adjustments. That is also the case for events occurring subsequent to the original issuance when financial statements are reissued in comparative form with financial statements of subsequent periods.

15.37 In addition, GASB Statement 34 paragraph 11(h), as amended, requires a discussion in MD&A of currently known facts, decisions, or conditions

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[8] See also Q&A section 9070.05, "Consideration of Impact of Losses From Natural Disasters Occurring After Completion of Audit Field Work and Signing of the Auditor's Report But Before Issuance of the Auditor's Report and Related Financial Statements" (AICPA, *Technical Questions and Answers*), which was issued in 2005.

that are expected to have a significant effect on the government's financial position or results of operations. GASB Statement No. 56, as amended, states that it may be necessary to include a discussion of subsequent events in the MD&A, depending on the facts and circumstances.

15.38 The size or other significance and timing of subsequent events will affect whether they are reported in the financial statements or the notes thereto. A government evaluates subsequent events for their effect on the financial statements, and the auditor evaluates subsequent events in relation to the fair presentation of the individual opinion unit(s) affected by the events.

15.39 Subsequent events may be identified by a government entity's management or discovered as a result of audit procedures applied to specific financial statement elements for other audit objectives or through cutoff testing and assessment of asset and liability valuations. In addition to standard audit procedures to identify subsequent events, procedures that are unique or significant in government may include the following:

- Reading minutes of meetings the governing board, or any other administrative board with management oversight, held since the financial statement date
- Reading the subsequent years' capital and operating budgets
- Reviewing the description in the management's discussion and analysis 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
- Reading articles published in paper or electronic form relating to facts and circumstances that may require adjustment of or disclosure in the government's financial statements

15.40 For a discussion of the auditor's responsibilities with respect to subsequent events, see AU-C section 560, *Subsequent Events and Subsequently Discovered Facts* (AICPA, *Professional Standards*). AU-C section 560 defines subsequent events similar to that in GASB Statement No. 56 but relative to those events that would have a material effect on the financial statements. It should be noted that in a state or local governmental financial statement audit, the auditor evaluates the reporting of subsequent events in relation to the fair presentation of the individual opinion unit(s) affected by the events.

15.41 When the audited financial statements include SI, note that under AU-C section 725, the auditor has no responsibility with respect to SI to consider subsequent events. However, if information comes to the auditor's attention prior to the report release date regarding subsequent events that affect the financial statements, the auditor should apply the relevant requirements of AU-C section 560. If information comes to the auditor's attention subsequent to the release of the report on the financial statements regarding facts that may have existed at that date, which might have affected the auditor report had the auditor been aware of such facts, the auditor should apply the relevant requirements of AU-C section 560.

Analytical Procedures

15.42 In addition to their use in planning an audit, AU-C section 520, *Analytical Procedures* (AICPA, *Professional Standards*), requires analytical procedures to be performed near the end of the audit that assist the auditor when forming an overall conclusion of the financial statement presentation for each opinion unit.[9] In addition, paragraph .22 of AU-C section 240 states that the auditor should evaluate whether analytical procedures performed as substantive tests or when forming an overall conclusion affect the assessment of the risk of material misstatement due to fraud. (Appendix A to chapter 4 of this guide discusses the provisions of AU-C section 240.)

Communicating With Those Charged With Governance

15.43 AU-C section 260 requires the auditor to determine that certain significant and relevant financial statement audit-related matters are communicated, orally or in writing, to those charged with governance of the entity. The term *those charged with governance* is defined in paragraph .06 of AU-C section 260, as "the person(s) or organization(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting and disclosure process." In most entities, governance is a collective responsibility that may be carried out by a board of directors, a committee of the board of directors (for example, an audit or legislative oversight committee), a committee of management (for example, a finance, budget, or governmental agency executive committee), partners, equivalent persons, or some combination of these parties. In some smaller entities, management and those charged with governance may be the same people, for example, the owner in an owner-managed entity or a sole trustee. In a government environment, examples of those charged with governance or management, or both (depending on the facts and circumstances), include governing boards, city councils, audit committees, mayors, governors, legislators, university or college presidents, certain other officials elected to a constitutional office, and chancellors. Because the governance structures of government entities and organizations receiving government funding can vary widely, it may not always be clearly evident who is charged with key governance functions. In these situations, auditors evaluate the organizational structure for directing and controlling operations to achieve the auditee's objectives. This evaluation also includes how the auditee delegates authority and establishes accountability for its management personnel. In situations in which the appropriate person(s) is not clearly identifiable, the auditor and engaging party may need to discuss and agree on the relevant person(s) within the governance structure with whom the auditor will communicate.

15.44 The specific matters to be communicated are listed in AU-C section 260. Additional matters to communicate are identified in the exhibit, "Requirements to Communicate With Those Charged With Governance in Other AU-C Sections," of AU-C section 260. In addition, AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*), establishes requirements and provides extensive guidance about communicating matters related to an entity's internal control over financial reporting identified while performing an audit of financial statements. AU-C section 265 also requires that certain communications be in writing.

15.45 Many auditors also communicate other information to audit or equivalent committees or to management even though not required by generally accepted auditing standards (GAAS). That is, the auditor may observe and

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[9] The AICPA Audit Guide *Analytical Procedures* provides practical guidance to auditors on the effective use of analytical procedures.

communicate through a "management letter" ways in which the entity could improve operational efficiency and effectiveness or otherwise improve internal control or other policies or procedures (other than those for which communication is required by GAAS). For example, the auditor may become aware of inappropriate budgeting techniques or estimates. With declining support from higher levels of government, declining tax bases, and other economic factors, governments sometimes use unique budgetary practices that may be inappropriate or unachievable. Even though not required by GAAS (unless the techniques or estimates represent errors, fraud, or noncompliance with laws and regulations), the auditor may want to communicate those observations and concerns to appropriate entity personnel.

Audit Documentation[10]

15.46 AU-C section 230, *Audit Documentation* (AICPA, *Professional Standards*), addresses the auditor's responsibility to prepare audit documentation.[11] The auditor should prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand

a. the nature, timing, and extent of the audit procedures performed to comply with GAAS and applicable legal and regulatory requirements;

b. the results of the audit procedures performed, and the audit evidence obtained; and

c. significant findings or issues arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions.

15.47 Paragraph .A10 of AU-C section 230 includes examples of significant audit findings and issues related to paragraph 15.46*c*. In governmental audits, significant audit findings could include, for example, not recording dispositions of general capital assets and not including an allowance for uncollectible receivables. In addition, paragraphs .43–.46 of AU-C section 240 states that the auditor should document certain procedures and conclusions relating to the consideration of fraud. When concluding the audit, the auditor should ensure that these and all other audit documentation requirements have been met. Appendix A to chapter 4 of this guide discusses consideration of fraud in a financial statement audit (AU-C section 240), including government-specific considerations.

15.48 For audit procedures related to the inspection of significant contracts or agreements, the auditor should include abstracts or copies of those contracts or agreements in the audit documentation. Governmental entities may have a number of large and complex contracts and agreements related to bonds issued, interjurisdictional agreements, grants, and other operating and financing agreements. Key provisions of these agreements, such as debt covenants

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[10] See also Q&A section 8345.02, "Considerations When Audit Documentation Has Been Destroyed by Fire, Flood, or Natural Disaster" (AICPA, *Technical Questions and Answers*), which was issued in 2005.

[11] Note that AU-C section 230, *Audit Documentation* (AICPA, *Professional Standards*), includes the exhibit "Audit Documentation Requirements in Other AU-C Sections."

for a revenue bond issue and eligibility requirements for a grant, are often relevant to the audit and may be subject to the documentation requirements of AU-C section 230.

15.49 Auditors should complete the assembly of the final audit file by the documentation completion date, which is defined by paragraph .06 of AU-C section 230 as no later than 60 days following the report release date. Documentation should be retained for at least 5 years from the report release date. After the documentation completion date, documentation should not be deleted or discarded during this retention period. If in rare circumstances, the auditor performs new or additional audit procedures or draws new conclusions after the date of the auditor's report, the auditor should document the addition in accordance with paragraph .14 of AU-C section 230.

Chapter 16

Audit Reporting

There are similarities, but important differences, between how GASB defines supporting information and how the AICPA auditing standards refer to that same information. The following is intended to clarify the two standard-setters' descriptions of the information and how the information will be referred to in the guide.

According to GASB Concepts Statement No. 3, *Communication Methods in General Purpose External Reports That Contain Basic Financial Statements*, supporting information places basic financial statements and notes to basic financial statements in an appropriate operational, economic or historical context. The information is either (1) required by GASB as required supplementary information (RSI) to be presented with the basic financial statements and the notes thereto; (2) supplementary information (SI), which is required by law or regulation to be presented; or (3) SI presented at the election of the preparer. SI as contemplated in GASB Concepts Statement No. 3 (preceding items 2–3) are referred to in this guide when describing GASB requirements as *"GASB defined" SI*. GASB Concepts Statement No. 3 limits its discussion of supporting information to "GASB defined" SI and RSI.

In contrast, the AICPA auditing standards refer to such supporting information as either RSI, other information (OI), or SI. AU-C section 730, *Required Supplementary Information* (AICPA, *Professional Standards*), defines RSI consistently with GASB literature. Therefore, references to such information in this guide are to RSI. AU-C section 720, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*), defines OI as financial and nonfinancial information (other than the financial statements and the auditor's report thereon) that is included in a document containing audited financial statements and the auditor's report thereon, excluding RSI. AU-C section 725, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*), defines *SI* as information presented outside the basic financial statements, excluding RSI that is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. This guide uses SI to describe information for which (1) the required conditions in AU-C section 725 have been met and (2) the auditor has been engaged to provide an "in relation to" opinion and OI for situations where the limited procedures in AU-C section 720 are required.

Introduction

16.01 Many governments are required to publish annual financial reports. Independent auditors often audit the financial statements in those reports. A government's management is responsible for the contents of the financial report. An independent auditor's primary responsibility is to report on whether the basic financial statements, including the notes thereto, are presented fairly in accordance with generally accepted accounting principles (GAAP).[1] The type of report the independent auditor issues depends primarily on the contents of the basic financial statements and on the scope and results of the audit.[2] This chapter discusses the auditor's report on governmental financial statements in various situations. Chapter 15, "Concluding the Audit," discusses the auditor's required communications with those charged with governance, including the audit committee and others.

16.02 The basic financial statements are defined by GASB and represent the minimum financial statements that should be prepared under GAAP. The basic financial statements generally contain government-wide financial statements, fund financial statements, and notes to the financial statements. The basic financial statements should be accompanied by RSI, which consists of management's discussion and analysis (MD&A) and, when applicable, other RSI.[3] Chapter 2, "Financial Reporting," provides an overview of the form and content of the basic financial statements and RSI. Other chapters of this guide provide more detail about certain aspects of those financial statements and RSI.

16.03 The auditor's primary responsibility is to report on the results of the audit of the basic financial statements. The auditor has additional responsibilities related to RSI and to supplementary information other than RSI (referred to in this guide as *"GASB defined" SI*). The auditor's responsibility for performing procedures on RSI and "GASB defined" SI is discussed in chapter 4, "General Auditing Considerations," and the auditor's responsibility for reporting on that information is discussed in paragraphs 16.63–.84. The basic financial statements are designed to include all information required for a fair and complete presentation in accordance with GAAP and may be issued without RSI or "GASB defined" SI, although the omission of RSI will affect the auditor's report. Specific "GASB defined" SI accompanies the basic financial statements in a Comprehensive Annual Financial Report (CAFR), as outlined in chapter 2.

Materiality

16.04 The primary objective of the audit of financial statements is the expression of an opinion on the fairness with which they present, in all material respects, financial information as of the date and for the period identified in accordance with GAAP. As discussed in chapters 4 and 15, auditors should plan, perform, and evaluate the results of audit procedures on a government's basic

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[1] Auditor's reports on basic financial statements that are presented using a comprehensive basis of accounting other than generally accepted accounting principles (GAAP), which are referred to as other comprehensive basis of accounting financial statements, are discussed in chapter 17, "Financial Statements Prepared in Accordance With a Special-Purpose Framework." Auditor's reports on summary financial information in popular reports are discussed in paragraphs 16.93–.102.

[2] Frequently, governments are required by statute or other mandate to have their financial statements audited in accordance with *Government Auditing Standards* (also referred to as the Yellow Book), issued by the Comptroller General of the United States. In addition, auditors may voluntarily choose to perform their work in accordance with *Government Auditing Standards*. For financial audits, *Government Auditing Standards* incorporates all AICPA auditing standards by reference. Additional *Government Auditing Standards* requirements and guidance relating to financial audits are discussed in the AICPA Audit Guide Government Auditing Standards *and Single Audits*.

[3] As discussed in chapter 2, "Financial Reporting;" and chapter 11, "The Budget"; GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, as amended, permits governments to elect to report certain required budgetary comparison information in a budgetary comparison statement as part of the basic financial statements, rather than as required supplementary information (RSI).

financial statements based on opinion units. Normally, the opinion units in a government's basic financial statements are (as applicable) the governmental activities; the business-type activities; the aggregate discretely presented component units; each major governmental and enterprise fund; and the aggregate remaining fund information (nonmajor governmental and enterprise funds, the internal service fund type, and the fiduciary fund types). As discussed in chapter 4, in certain circumstances, auditors may choose to combine the two aggregate opinion units—the one for the aggregate discretely presented component units and the one for the aggregate remaining fund information—into a single opinion unit. The resulting combined unit is referred to as the *aggregate discretely presented component units and remaining fund information* opinion unit.

16.05 AU-C section 700, *Forming an Opinion and Reporting on Financial Statements* (AICPA, *Professional Standards*), requires that the auditor either express an opinion regarding the financial statements as a whole, or state that an opinion cannot be expressed, in the auditor's report. In reporting on a government's basic financial statements, the auditor should either express an opinion regarding the financial statements for each opinion unit or state that an opinion on one or more opinion units cannot be expressed, in the auditor's report. Generally, the auditor expresses or disclaims an opinion on a government's financial statements as a whole by providing opinions or disclaimers of opinion on each opinion unit. See paragraph 16.10 for further discussion.

16.06 Paragraph .A18 of AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report* (AICPA, *Professional Standards*), states that, because the auditor of a government's basic financial statements expresses an opinion or disclaims an opinion on each opinion unit, an auditor's report in these circumstances may express an unmodified opinion on the financial statements of one or more opinion units and modified opinions or disclaimers of opinion on one or more of the other opinion units. However, as discussed in paragraph 16.10, there are situations in which an adverse opinion or disclaimer of opinion should be given for the government's basic financial statements as a whole.

16.07 The auditor's evaluation of the results of audit procedures that would lead to an opinion modification on one opinion unit may or may not result in an opinion modification on another opinion unit. For example, a GAAP departure may result in an opinion modification on a major governmental fund opinion unit. The auditor may conclude that the effect of that departure also has a material effect on the presentation of governmental activities and therefore also modify the opinion on the governmental activities opinion unit. On the other hand, the auditor may conclude that the effect of that departure does not materially affect governmental activities, and not modify the opinion on the governmental activities opinion unit for the departure. (See the illustrative auditor's report in appendix A [example A-5].)

16.08 Similarly, the auditor may conclude that the effect of a GAAP departure has a material effect on, for example, the governmental activities opinion unit, but that the departure does not similarly affect the opinion units that include governmental funds. For example, if a government does not accrue material compensated absences liabilities relating to governmental activities, that nonaccrual may result in a modified opinion on the governmental activities opinion unit, but not directly affect the auditor's opinions on the opinion units that include governmental funds, which only accrue compensated absences liabilities to the extent the liability has matured (come due for payment). (See the illustrative auditor's report in appendix A [example A-7].) As discussed in chapter 2, GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, as amended, requires reconciliations to the government-wide financial statements to be presented with the fund financial statements. In developing opinions on the opinion units, the auditor should view the financial statement reconciliations as relating to the presentation of the governmental activities and business-type activities opinion units, as discussed in chapter 4.

Update 16-1 *Fiduciary Activities*

GASB Statement No. 84, *Fiduciary Activities*, establishes criteria for identifying and reporting fiduciary activities. The criteria for identification of fiduciary activities primarily focuses on (*a*) whether a government controls the assets of the fiduciary activity and (*b*) the beneficiaries with whom a fiduciary relationship exists.

Governments with activities meeting the criteria will present a statement of fiduciary net position and a statement of changes in fiduciary net position, with certain exceptions.

There are four classifications of fiduciary funds described in GASB Statement No. 84: (1) pension (and other employee benefit) trust funds, (2) investment trust funds, (3) private-purpose trust funds, and (4) custodial funds. Custodial funds should report fiduciary activities that are not held in a trust or equivalent arrangement that meets specific criteria.

The statement was issued in January 2017 and is effective for fiscal years beginning after December 15, 2018. Earlier application is encouraged.

Upon its effective date, GASB Statement No. 84 will affect the guidance in this chapter.

The full text of the statement is available on GASB's website at www.gasb.org.

16.09 As discussed in chapter 4, the financial statements for some special-purpose governments engaged only in business-type activities (such as utilities) and for special-purpose governments engaged only in fiduciary activities (such as public employee retirement systems—PERS) will have a single opinion unit (provided the government has no discretely presented component units). Thus, the auditor will give a single opinion on those financial statements.[4] In those situations, the auditor should either express an opinion regarding the financial statements as a whole, or state that an opinion on the financial statements as a whole cannot be expressed, in the auditor's report.

16.10 For entities with more than one opinion unit, certain egregious situations will result in the auditor expressing an adverse opinion or disclaimer of opinion on the financial statements as a whole:

- The auditor should express an adverse opinion on the financial statements as a whole when the required government-wide or fund financial statements are not presented.

[4] Some special-purpose governments engaged only in business-type activities have more than one opinion unit, for example, because they have more than one enterprise fund or because they report fiduciary activities in fiduciary funds. Therefore, the auditor's report will provide more than one opinion.

- The auditor should express an adverse opinion on the financial statements as a whole when adverse opinions are appropriate for both the governmental activities and business-type activities opinion units (or for only the governmental activities opinion unit if that is the only required presentation for the primary government in the reporting entity's government-wide financial statements).
- The auditor should express a disclaimer of opinion on the financial statements as a whole when disclaimers of opinion are appropriate for both the governmental activities and business-type activities opinion units (or for only the governmental activities opinion unit if that is the only required presentation for the primary government in the reporting entity's government-wide financial statements).

Other situations occur in which adverse opinions or disclaimers of opinion on one or more opinion units are appropriate. In those situations, the auditor should use professional judgment to evaluate the facts and circumstances of those opinion modifications to determine whether the financial statement presentations on which the auditor is considering issuing a modified report are of such a nature that the financial statements, as a whole, are not presented fairly in accordance with GAAP or if it is appropriate to disclaim an opinion on the financial statements as a whole. (See the illustrative auditor's report of an adverse opinion on the financial statements as a whole in appendix A (example A-8).

16.11 As discussed in chapter 4, the terms of an audit engagement may cause the auditor to set the scope of the audit and assess materiality at a more-detailed level than at the opinion unit level used for the basic financial statements (for example, at an individual fund or fund type level). Paragraphs 16.60–.62 discuss auditor reporting in those situations.

Specific Issues in Reporting on the Audits of Governmental Financial Statements

Basic Financial Statements

16.12 The auditor's standard report on a government's basic financial statements states that the financial statements present fairly, in all material respects, the financial position, changes in financial position, and, where applicable, cash flows of each opinion unit in those financial statements in accordance with GAAP. (See paragraph 16.17 for a discussion of changes to the standard report if the basic financial statements contain a single opinion unit.) The basic elements of the standard report are listed in paragraphs .23–.41 of AU-C section 700[5] and include

- a title that includes the word *independent*;

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[5] The PCAOB establishes standards for audits of *issuers*, as that term is defined by the Sarbanes-Oxley Act of 2002 or whose audit is prescribed by the rules of the SEC. Other entities are referred to as *nonissuers*. Paragraphs .42–.44 of AU-C section 700, *Forming an Opinion and Reporting on Financial Statements* (AICPA, *Professional Standards*), provides guidance for the auditor's report for audits conducted in accordance with both GAAS and another set of auditing standards (for example, the PCAOB or *Government Auditing Standards*).

- the addressee;
- an introductory paragraph;
- a section with the heading "Management's Responsibility for the Financial Statements";
- a section with the heading "Auditor's Responsibility";
- a section with the heading "Opinion";
- when applicable, a section subtitled "Report on Other Legal and Regulatory Requirements";
- signature of the auditor; and
- date of the auditor's report.

The auditor's report should also include an "Other Matter" paragraph as discussed in AU-C section 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report* (AICPA, *Professional Standards*), because GASB requires basic financial statements to be accompanied by RSI, which is considered an other-matter. If the auditor's report contains a separate section on other reporting responsibilities, the headings, statements, and explanations referred to in paragraphs .25–.36 of AU-C section 700 should be under the subtitle "Report on the Financial Statements." The "Report on Other Legal and Regulatory Requirements" section should follow the "Report on the Financial Statements." The form of the auditor's standard report on a government's basic financial statements covering a single year, when reporting on accompanying RSI, SI, and OI[6] is shown in appendix A (example A-1).

The Auditor's Report

16.13 A description of the format and content of an auditor's report for audits conducted in accordance with generally accepted auditing standards (GAAS) is provided in AU-C section 700. This guide discusses the nuances of applying AU-C section 700 to state and local government reporting; auditors should refer to the standard for all reporting requirements.

The Introductory Paragraph

16.14 The introductory paragraph of the auditor's report should refer to the audit of the financial statements of each opinion unit, even though some of those opinion units do not have distinct or separate financial statements. For example, there usually will not be a single set of financial statements for the "aggregate remaining fund information." However, the reference in the introductory paragraph to the financial statements for the aggregate remaining fund information is meant to refer to the aggregate of the financial statements for the funds and fund types that comprise that opinion unit. The introductory paragraph should identify the financial statements being audited. Usually, this identification includes reference to the table of contents or to the pages on which the financial statements are displayed. It is appropriate to refer to the table of contents only if the financial statements for which the reference is made are listed in the table of contents.

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[6] There is no requirement to report on other information (OI) in AU-C section 720, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*). Paragraph .A13 of AU-C section 720 provides an example of an other-matter paragraph that the auditor may use to disclaim an opinion on OI.

16.15 When the auditor disclaims an opinion due to the inability to obtain sufficient appropriate audit evidence, the auditor should amend the introductory paragraph to state the auditor was "engaged to audit" the financial statements.

16.16 The introductory and opinion paragraphs of the auditor's report will refer in a general manner to the government's major funds, rather than separately naming individual major funds. Major funds should be evident from the basic financial statements (for example, if the financial statements, through labeling or disclosure, indicate which governmental and enterprise funds are major)[7] and should be identified in the summary of significant accounting policies in accordance with paragraph 6 of GASB Statement No. 38, *Certain Financial Statement Note Disclosures*. When the major funds are evident from the basic financial statements, there is a presumption that the report users will be able to reasonably determine the major funds on which the auditor is opining. However, if the distinction as to which funds are major is made by disclosure, the auditor may also name the major funds in the report to make the scope of the audit and the opinions on the opinion units clear to the report user. In cases when there are different types of opinions, the illustrative reports in this chapter include a table to illustrate an additional way for the auditor to communicate that more than one type of opinion is being issued. The table's inclusion may assist users in more easily understanding the report, but it is not a required element. See example A-4 in appendix A of this chapter for an example.

16.17 As discussed in paragraph 16.09, the financial statements for some special-purpose governments engaged only in business-type activities and for special-purpose governments engaged only in fiduciary activities will have a single opinion unit and, thus, the auditor will give a single opinion on those financial statements.[8] See the illustrative auditor's report in appendix A (example A-2). If, however, such a special-purpose government has one or more discretely presented component units, there will be more than one opinion unit. See the illustrative auditor's report in appendix A (example A-3).

Management's Responsibility for the Financial Statements

16.18 The auditor's report should include a section with the heading "Management's Responsibility for the Financial Statements." This section should describe management's responsibility for the preparation and fair presentation of the financial statements, including an explanation that management is responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework. This responsibility includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error. The description about management's responsibility for the financial statements in the auditor's report should not be referenced to a separate statement by management about such responsibilities if such a statement is included in a document containing the auditor's report.

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[7] Question 7.56.8 of the GASB *Implementation Guide No. 2015-1* states that the government should clearly distinguish between major and nonmajor funds and provides an example of how that can be accomplished.

[8] See footnote 4.

Auditor's Responsibility

16.19 This section should include the heading "Auditor's Responsibility" and should state that the auditor's responsibility is to express opinions on the financial statements based on the auditor's audit. However, even though the auditor's report generally will provide more than one opinion, the auditor is conducting only one audit. Therefore, this section refers to only one audit. Note there are cases in which there is only one opinion unit, see paragraph 16.12, in which case the reference would then be to opinion rather than opinions.

16.20 Based on paragraph .28 of AU-C section 705, when the auditor disclaims an opinion due to an inability to obtain appropriate audit evidence, the auditor should amend the "Auditor's Responsibility" section as follows:

> Our responsibility is to express opinions on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement. Because of the matter(s) described in the "Basis for Disclaimer of Opinion" paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the [*identify the opinion unit*].

16.21 If the government presents the required budgetary comparison information as a basic financial statement rather than as RSI (see chapter 11, "The Budget"), the scope of the audit for the general and each major special revenue fund that has a legally adopted annual budget should encompass the required budgetary comparison information. The opinion paragraph should also refer to the budgetary comparisons for those funds. See the discussion in footnotes in appendix A in examples A-1, A-5, A-16, and A-17.

Auditor's Opinion

16.22 This section should include the heading "Opinion" or "Opinions" if there are multiple opinion units. When expressing an unmodified opinion on a government's basic financial statements, the opinion paragraph should state that the financial statements present fairly, in all material respects, the financial position, changes in financial position, and, where applicable, cash flows of each opinion unit in those financial statements in accordance with GAAP or the applicable financial reporting framework and its origin. Modifications to opinions are discussed in paragraphs 16.25–.35.

Other Reporting Responsibilities

16.23 If the auditor addresses other reporting responsibilities in the auditor's report on the financial statements that are in addition to the auditor's responsibility under GAAS to report on the financial statements, these other reporting responsibilities should be addressed in a separate section in the auditor's report that should be subtitled "Report on Other Legal and Regulatory Requirements" or otherwise, as appropriate to the content of the section. An example of such reporting would be for audits conducted under *Government Auditing Standards* which require the auditor to report on internal control over financial reporting and compliance with laws, regulations, and provisions of contracts or grant agreements.

Emphasis of Matter and Other-Matter Paragraphs

16.24 Certain circumstances, although not affecting the auditor's unmodified opinion on the financial statements, may require that the auditor add an emphasis-of-matter or other-matter paragraph to the auditor's report. Paragraph .05 of AU-C section 706 provides the following definitions:

> *Emphasis-of-matter paragraph*. A paragraph included in the auditor's report that is required by GAAS, or is included at the auditor's discretion, and that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's professional judgment, is of such importance that it is fundamental to users' understanding of the financial statements.
>
> *Other-matter paragraph*. A paragraph included in the auditor's report that is required by GAAS, or is included at the auditor's discretion, and that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's professional judgment, is relevant to users' understanding of the audit, the auditor's responsibilities, or the auditor's report.

Departures From the Standard Report[9]

Basis for Modification Paragraph

16.25 Paragraph .17 of AU-C section 705 requires the auditor to include, in addition to the elements of the auditor's report specified in AU-C section 700, a paragraph that provides a description of the matter giving rise to the modification. The paragraph should be placed before the opinion paragraph and use a heading that includes "Basis for Qualified Opinion, Basis for Adverse Opinion," or "Basis for Disclaimer of Opinion," as appropriate. Even if the auditor has expressed an adverse opinion or disclaimed an opinion on the financial statements, the auditor should (*a*) describe in the basis for modification paragraph any other matters of which the auditor is aware that would have required a modification to the opinion and the related effects and (*b*) consider the need to describe in an emphasis-of-matter paragraph or other-matter paragraph(s) regarding any other matters of which the auditor is aware that would have resulted in additional communications in the auditor's report on the financial statements that are not modifications of the auditor's report.

16.26 The following sections explain the types of conditions that may lead to an opinion modification and illustrates or refers to report language for those modifications. Specific situations that may require changes in the standard report language are discussed in paragraphs 16.36–.39.

Scope Limitations

16.27 A lack of sufficient appropriate audit evidence or restrictions on the scope of the audit of the financial statements for an opinion unit may lead the auditor to qualify the opinion or disclaim an opinion on that opinion unit. A scope limitation is present if a portion of a governmental reporting entity is not audited. A scope limitation that arises from a lack of sufficient appropriate

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[9] The AICPA Audit Guide Government Auditing Standards *and Single Audits* contains information on additional reporting standards and illustrative auditor's reports for audits conducted in accordance with *Government Auditing Standards*. This publication is available for purchase at www.AICPAStore.com.

audit evidence to support a financial statement assertion may involve circumstances in which, for example, a government's accounting systems, processes, and records do not provide sufficient information to enable the government to

- report interfund activity and balances in the fund financial statements,
- eliminate internal activity and balances in the government-wide financial statements, or
- report capital assets in accordance with GAAP.

The auditor also should consider whether the entity's presentation constitutes a departure from GAAP. A scope limitation arising from insufficient audit evidence also could involve a situation in which an auditor is unable to obtain information about internal control over service organization services that are part of the government's information system.

Qualified Opinion—Scope Limitations

16.28 When a qualified opinion results from a limitation on the scope of the audit or insufficient audit evidence, the auditor should describe the circumstances in the basis for modification paragraph before the opinion paragraph and use a heading that includes "Basis for Qualified Opinion." The heading of the opinion paragraph should include "Qualified Opinion." An example of a qualified opinion when a government does not obtain an audit of one or more (but not all) discretely presented component units that are material to the aggregate discretely presented component unit opinion unit, and the auditor determines that a qualification of opinion is appropriate, is shown in appendix A (example A-4).

Disclaimer of Opinion—Scope Limitations[10]

16.29 A disclaimer of opinion states that the auditor does not express an opinion on the financial statements for one or more opinion units (or for the financial statements as a whole as discussed in paragraphs 16.10 and 16.31). A disclaimer is appropriate when the auditor has not performed an audit sufficient in scope to enable the auditor to form an opinion on the financial statements for the opinion unit or when the client imposes restrictions that significantly limit the scope of the audit. When disclaiming an opinion on an opinion unit because of a scope limitation, the auditor should describe the circumstances in the basis for modification paragraph before the opinion paragraph and use a heading that includes "Basis for Disclaimer of Opinion." The opinion paragraph should use a heading that includes "Disclaimer of Opinion."

16.30 An example basis for modification paragraph when one or more (but not all) discretely presented component units are not audited, and the auditor determines that a disclaimer of opinion is appropriate, is shown in appendix A (example A-12).

16.31 As discussed in paragraph 16.10, there may be situations in which, for entities with more than one opinion unit, the auditor will disclaim an

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[10] See also Q&A section 8345.01, "Audit Considerations When Client Evidence and Corroborating Evidence in Support of the Financial Statements Has Been Destroyed by Fire, Flood, or Natural Disaster" (AICPA, *Technical Questions and Answers*), which was issued in 2005 and discusses a disclaimer of opinion if substantially all of an entity's evidence and corroborating evidence in support of the financial statements has been destroyed and the auditor has been unable to complete audit procedures with respect to financial statement amounts and assertions.

opinion on the financial statements as a whole. In those situations, the auditor should state in a separate basis for modification paragraph all of the substantive reasons for the disclaimer on the financial statements as a whole. See the illustrative auditor's reports in paragraph .A32 of AU-C section 705.

Departures From GAAP

16.32 A departure from GAAP in the financial statements for an opinion unit may lead the auditor to qualify the opinion or express an adverse opinion on that opinion unit. Some of the departures from GAAP that, depending on the materiality of the effect, may require an opinion modification for one or more opinion units include:

- Financial information, for example, for a fund, department, agency, or program, or one or more (but not all) component units, is omitted from the financial statements. (See the discussion concerning omitted major funds in paragraph 16.53 and omitted component units in paragraphs 16.54–.57.)
- A portion of the reporting entity does not apply GAAP, for example, a component unit is on a cash basis of accounting.
- General capital assets are omitted from the government-wide financial statements.
- The entity accounts for infrastructure assets using the modified approach even though it no longer qualifies to do so. (See the detailed discussion about the modified approach in chapter 7, "Capital Assets.")
- The fund financial statements do not report one or more governmental or enterprise funds as major in accordance with the quantitative criteria of GASB Statement No. 34, as amended. (See paragraph 16.53.)
- A required note disclosure is omitted or is not presented in accordance with GAAP.

Qualified Opinion—Departures From GAAP

16.33 When the auditor expresses a qualified opinion, the auditor should include a basis of modification paragraph before the opinion paragraph that includes the heading "Basis for Qualified Opinion" that explains, for each affected opinion unit, (*a*) all of the substantive reasons that have led him or her to conclude that there has been a departure from GAAP and (*b*) the principal effects of the subject matter of the qualification on the financial position, changes in financial position, or, where applicable, cash flows, if practicable, or a statement that the effects are not reasonably determinable. The opinion paragraph of the report also should include the appropriate qualifying language and a reference to the basis for modification paragraph. Appendix A examples A-5 and A-10 illustrate qualified opinions for departures from GAAP.

Adverse Opinion—Departures From GAAP

16.34 An adverse opinion states that the financial statements for an opinion unit (or for the financial statements as a whole as discussed in paragraph 16.35) do not present fairly the financial position, changes in financial position, or, where applicable, cash flows in accordance with GAAP. When the auditor expresses an adverse opinion for an opinion unit, the auditor's report should include a separate basis for modification paragraph before the opinion paragraph that uses the heading "Basis for Adverse Opinion." The opinion paragraph should use a heading that includes "Adverse Opinion." The basis for modification paragraph makes the same explanations about the adverse opinion as discussed in paragraph 16.33 for a qualified opinion.

- An example of an adverse opinion on governmental activities because those financial statements do not include certain general infrastructure assets is shown in appendix A (example A-6). The auditor should consider quantitative and qualitative factors in determining whether the omission of general infrastructure assets requires an opinion modification and, if so, whether the modification should be a qualified or an adverse opinion. Because a general-purpose government's general infrastructure assets are presumed to be material in relation to its governmental activities unless demonstrated otherwise, an adverse opinion usually would be appropriate. Such a presumption does not exist for special-purpose governments because some special-purpose governments, such as school districts, generally have little or no general infrastructure assets. Further, some auditors may conclude that the omission of general infrastructure assets cause the financial statements, as a whole, not to be presented fairly in accordance with GAAP.
- An example of an adverse opinion because a government does not accrue compensated absences liabilities and expenses for governmental activities is shown in appendix A (example A-7).
- An example of an adverse opinion because a government does not report an enterprise fund as major in accordance with the quantitative criteria of GASB Statement No. 34, as amended, is shown in appendix A (example A-10). (See the further discussion in paragraph 16.53.)
- An example of an adverse opinion on the aggregate discretely presented component unit opinion unit because a government issues separate primary government basic financial statements without also issuing audited financial statements for the reporting entity is shown in appendix A (example A-13). (See the further discussion in paragraph 16.56.)

16.35 As discussed in paragraph 16.10, there may be situations in which an adverse opinion(s) on the financial statements of an entity with more than one opinion unit will result in the auditor expressing an adverse opinion on the financial statements as a whole. An example of an adverse opinion when a government does not present government-wide financial statements is shown in appendix A (example A-8).

Special Situations

Part of the Audit Performed by a Component Auditor

16.36 There are many situations in which another auditor is involved in auditing a portion of a reporting entity. Usually involvement of another auditor relates to auditing component units. Chapter 4 discusses the requirements of AU-C section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* (AICPA, *Professional Standards*), to identify the group engagement team responsibilities in those situations. The group engagement partner should consider the guidance in chapter 4 concerning whether to assume responsibility for the work of a component auditor and, thereby, whether to refer in the auditor's report to the work of a component auditor. When the group engagement partner decides to refer to the audit of a component auditor in the auditor's report on the group financial statements, the report on the group financial statements should clearly indicate that the component was not audited by the auditor of the group financial statements but was audited by the component auditor and should include the magnitude of the portion of the financial statements audited by the component auditor.

16.37 If the group engagement partner decides to refer to a component auditor in the auditor's report on the group financial statements

a. the component auditor's express permission should be obtained.

b. the component auditor's report should be presented together with that of the auditor's report on the group financial statements.

If the group engagement auditor decides to assume the responsibility for the work of a component auditor, no reference should be made to the component auditor in the auditor's report on the group financial statements. Appendix A (example A-9) illustrates a report that refers to the audit of a component auditor.

16.38 If the opinion of a component auditor is modified or that report includes an emphasis-of-matter or other-matter paragraph, the auditor of the group financial statements should determine the effect that this may have on the auditor's report on the group financial statements. When deemed appropriate, the auditor of the group financial statements should modify the opinion on the group financial statements or include an emphasis-of-matter or other-matter paragraph in the auditor's report on the group financial statements.

16.39 Paragraph 16.85 discusses the effect on the auditor's report on the group financial statements of a component auditor's work on RSI and SI.

Subcontracting, Joint Audits, and Joint Ventures

16.40 An auditor occasionally performs an audit with another auditor, for example, a state auditor's office or a minority-owned or small firm. When another auditor is involved on a subcontract basis, only the auditor of the firm engaged to issue the audit report signs the auditor's report.

16.41 When the audit is performed on a joint basis, the auditors participating in the audit each sign the report in their individual capacities. AICPA standards do not provide for two or more auditors to divide the responsibility for an audit of the basic financial statements of a single entity. That is, each individual or firm signing an audit report is considered to be separately expressing the opinion(s) in the report. Each individual or firm that signs the report should have complied with GAAS as if they were the only signatory of the report.

16.42 A joint venture by two firms to conduct an audit takes the form of a legal entity, just as individuals band together to form a firm. In that situation, the audit report might be signed with the joint venture name. However, before using such an approach, the auditors should consider the implications of ethics rules on the use of fictitious names and state licensing statutes that may not recognize such an entity.

Preferable Accounting Policies

16.43 As discussed in paragraph .07 of AU-C section 708, *Consistency of Financial Statements* (AICPA, *Professional Standards*), one of the objectives of the auditor is to communicate appropriately in the auditor's report when the comparability of financial statements between periods has been materially affected by a change in accounting principle. The auditor should determine whether such a change in accounting principle meets the criteria in paragraph .07 of AU-C section 708 and whether an emphasis-of-matter paragraph is required.

16.44 In making the evaluation, the auditor should consider whether the standards setter has identified a particular practice as preferable or encouraged.[11] An accounting principle is preferable if the standards setter has identified it as such. If, instead, the standards setter has identified a principle as encouraged, that fact is considered in conjunction with other facts and circumstances (such as industry practice) in applying professional judgment to conclude whether an accounting principle is preferable. If a change is made to a less preferable method or without reasonable justification, and if the effect of the change is material, the auditor should express a qualified or adverse opinion for the affected opinion units. A change in a display principle would be less likely to be material than a change in a measurement or recognition principle. The auditor's consideration of and reporting on changes in accounting principles are discussed in paragraphs .08–.12 of AU-C section 708.

Prior-Period Financial Information

16.45 Sometimes, a government's basic financial statements include financial information from a prior period. This may be done in one of two ways: (*a*) a complete presentation or (*b*) a partial or summarized presentation. (A government's financial report also may include prior-year information presented as RSI or "GASB defined" SI. Paragraph 16.63 discusses certain considerations relating to that situation. In addition, paragraph 16.73 discusses the presentation of MD&A when comparative prior-year financial statements are presented.)

Complete Presentation of Prior-Period Financial Information

16.46 As discussed in chapter 2, a complete presentation of prior-period financial information occurs when a government includes the complete basic financial statements from the prior period. That presentation may include additional information on the face of the current-period statements or may include both current-period and prior-period statements. Paragraphs .A43–.A45 of AU-C section 700 state that the level of information included for the prior periods in comparative financial statements is comparable with that of the financial statements of the current period. Because the auditor's report on comparative financial statements applies to the financial statements for each of the periods presented, the auditor may express a qualified opinion or an adverse opinion, disclaim an opinion, or include an emphasis-of-matter paragraph with respect to one or more financial statements for one or more periods while expressing

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[11] Although GASB standards do not identify any alternatives as preferable, they do state or imply that the use of certain alternatives are encouraged. Appendix A, "Accounting and Financial Reporting Alternatives in GASB Statement No. 34, as Amended," to chapter 2 lists certain accounting and financial reporting alternatives contained in GASB standards and identifies those that are encouraged.

a different auditor's opinion on one or more financial statements of another period presented.[12]

16.47 If the prior-period financial statements include the minimum information required by GAAP for a complete set of financial statements, a continuing auditor should report on them.[13] When complete comparative financial statements are presented and the auditor has not been engaged to audit the prior-period financial statements, the government may request the predecessor auditor to reissue the auditor's report. Paragraphs .19–.20 of AU-C section 560, *Subsequent Events and Subsequently Discovered Facts* (AICPA, *Professional Standards*), provide guidance regarding such a reissuance. Paragraphs .54–.55 of AU-C section 700 address the auditor's responsibility when the prior auditor's report is not presented.

Partial or Summarized Presentation of Prior-Period Financial Information

16.48 Partial or summarized presentations of prior-period comparative financial information result when the government presents less than the full basic financial statements from the prior period. (Chapter 2 discusses the display of and disclosure relating to such partial or summarized presentations.) This may be the result of including only some of the prior-period required financial statements or of including only a prior-period total column on a financial statement that requires multiple columns. Paragraph .46 of AU-C section 700 provides that if comparative information is presented but not covered by the auditor's opinion, then the auditor's report should clearly indicate the character of the auditor's work, if any, and the degree of responsibility the auditor is taking. If comparative information is presented and the entity requests the auditor to express an opinion on all periods presented, paragraph .47 of AU-C section 700 requires the auditor to consider whether the prior period information contains sufficient detail to constitute a fair presentation in accordance with the applicable reporting framework.

16.49 Regarding condensed financial statements or prior period summarized financial information, paragraph .A47 of AU-C section 700, states the following:

> Comparative information, which may be condensed financial statements or prior period summarized financial information, is not considered comparative financial statements because it is not a complete set of financial statements. For example, entities such as state and local governmental units frequently present total-all-funds information for the prior periods rather than information by individual funds because of space limitations or to avoid cumbersome or confusing formats.

16.50 If prior-period financial information is a partial or summarized presentation (or a combination of partial and summarized information) and therefore does not include the minimum information required by GAAP for a complete set of financial statements, a continuing auditor's report should not

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[12] The auditor's consideration of this guidance from AU-C section 700 should be applied within the context of reporting on a government's financial statements based on opinion units as discussed in chapter 4, "General Auditing Considerations," and earlier in this chapter.

[13] See paragraph 16.73 for a discussion of comparative information in management's discussion and analysis.

mention the prior-period information in the description of the financial statements audited or in the opinion paragraph, although an other-matter paragraph may be needed if disclosures related to prior period information are incomplete, as discussed in paragraph 16.51. A continuing auditor should, however, make clear the degree of responsibility that the auditor is assuming in relation to the prior-period information by stating in a separate paragraph (*a*) that the partial or summarized information has been derived from a complete set of financial statements, (*b*) the date of the auditor's report on the complete financial statements,[14] and (*c*) the type of opinions expressed.[15,16] According to paragraph .A48 of AU-C section 700, the guidance in AU-C section 930, *Interim Financial Information* (AICPA, *Professional Standards*), may be adapted to report on condensed financial statements or prior period summarized financial information that is derived from audited financial statements and is presented comparatively with the complete set of financial statements of the current period. The following example of such an other-matter paragraph is based on Illustration 4, "An Auditor's Report on a Single Year Prepared in Accordance With Accounting Principles Generally Accepted in the United States of America When Comparative Summarized Financial Information Derived From Audited Financial Statements for the Prior Year Is Presented" of AU-C section 700 (example A-9):

> **Other Matter**
>
> *Prior-Year Comparative Information*
>
> We have previously audited the City's 20PY financial statements, and we expressed unmodified opinions on the respective financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information in our report dated September 15, 20PY. In our opinion, the summarized comparative information presented herein as of and for the year ended June 30, 20PY, is consistent, in all material respects, with the audited financial statements from which it has been derived.

16.51 As discussed in chapter 2, if the prior-period financial information does not include the minimum information required by GAAP, disclosure should be made about the nature of the information presented. The auditor should evaluate the adequacy of that disclosure. If the disclosure is omitted or

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[14] Reference to the date of the original report removes any implication that records, transactions, or events after that date have been examined. The auditor does not have a responsibility to investigate or inquire further into events that may have occurred during the period between the date of the original report on the complete financial statements and the date of the current report that refers to the summarized information.

[15] If the auditor's opinions on the financial statements were other than unmodified, the report should describe the nature of, and the reasons for, the opinion modifications. The auditor also should consider the effect that any modification of the original report on the financial statements might have on the current report that refers to the summarized information. For example, if the original auditor's report referred to another auditor or included an emphasis-of-matter paragraph because of a material uncertainty, a going-concern matter, or an inconsistency in the application of accounting principles, the current report that refers to the summarized information should state that fact. However, no reference to the inconsistency is necessary if a change in accounting referred to in the original auditor's report on the complete financial statements does not affect the comparability of the information currently being presented.

[16] If prior-period partial or summarized information has been derived from financial statements that were audited by another auditor, the report should state that fact, and the auditor should not express an opinion on that information.

incomplete, the auditor should, if considered relevant to the users' understanding of the audit, add an other-matter paragraph, as described in paragraph .08 of AU-C section 706, calling the omitted or incomplete disclosure to the users' attention. Such an other-matter paragraph might read as follows:

> **Other Matter**
>
> *Prior-Year Comparative Information*
>
> The financial statements include [*partial or summarized*] prior-year comparative information. Such information does not include [*all of the information required or sufficient detail to constitute*] a presentation in accordance with accounting principles generally accepted in the United States of America. Accordingly, such information should be read in conjunction with the government's financial statements for the year ended June 30, 20PY, from which such [*partial or summarized*] information was derived.

Year-to-Year Changes in Major Funds

16.52 As discussed in chapter 2, major governmental and enterprise funds are determined in one of two ways. Some major funds are determined using quantitative criteria specified by GAAP. Other governmental and enterprise funds are presented as major based on management's judgment that the funds are particularly important to financial statement users. The standards for selecting major funds could result in different funds being reported as major each year. The quantitatively determined major funds may change due to changes in the relative financial information reported in various funds. The judgmentally determined major funds may change due to changing circumstances in the government. Such changes should not be considered a change in accounting principles affecting consistency, and thus no modification to the auditor's report is needed.

Major Fund Not Displayed or Not Separately Displayed

16.53 As indicated in paragraph 16.32, it is a departure from GAAP if the fund financial statements do not report one or more governmental or enterprise funds as major in accordance with the quantitative criteria of GASB Statement No. 34, as amended. In that situation, the auditor should report adverse opinions on the omitted major fund opinion units because the omitted displays always are considered material departures from GAAP. Appendix A (example A-10) illustrates an adverse opinion on a major fund opinion unit when the fund is not included in the financial statements. When an adverse opinion on an omitted major fund opinion unit is expressed because the fund is included in the financial statements but incorrectly displayed with nonmajor governmental or enterprise funds, the auditor also should modify the opinion on the aggregate remaining fund information opinion unit. The nature of the modification on the aggregate remaining fund information opinion unit (that is, whether it is a qualified or adverse opinion) should be based on the facts and circumstances surrounding the effect that including the fund has on the remaining fund information. (Chapter 10, "Net Position and Financial Statement Reconciliations," discusses the auditor's consideration when a fund that is major in the current year's audit was not a major fund in the previous year's audit.)

Financial Statements That Include Only Part of the Reporting Entity[17]

Omission of Component Units

16.54 As discussed in chapter 3, "The Financial Reporting Entity," GASB Statement No. 14, *The Financial Reporting Entity*, as amended, contains the standards for defining the governmental financial reporting entity and for identifying which legally separate entities are component units that should be included with another government (usually a primary government) in a financial reporting entity's financial statements. GASB Statement No. 14 paragraph 64 recognizes that there may be circumstances in which a primary government issues separate basic financial statements that exclude all component units (both blended and discretely presented), and requires that the limitations of the basic financial statements be clearly disclosed. In addition, the GASB *Implementation Guide No. 2015-1* (IG 2015-1) questions 4.42.1 and 4.42.2 indicate that "primary government-only" financial statements should supplement, not supplant, the financial statements of the reporting entity. Because of those requirements, the status of basic financial statements that present only the primary government and the auditor's reporting on those financial statements depends on whether the entity also has issued audited financial statements for the reporting entity.

16.55 If the government also has issued audited financial statements for the reporting entity, the auditor's report on separate primary government basic financial statements, as illustrated in appendix A (example A-11), should contain the elements in the following listing. Without those elements, such separate basic financial statements for the primary government could be misinterpreted to be the complete basic financial statements of the financial reporting entity. An emphasis-of-matter paragraph should be used to communicate the following elements:

- Indicate that the financial statements are those of the primary government and not of the financial reporting entity.
- Define the term *primary government.*
- Indicate that the primary government's financial statements do not purport to, and do not, fairly present financial position, changes in financial position, or, where applicable, cash flows of the financial reporting entity in accordance with GAAP.
- Indicate that the entity has issued separate audited reporting entity financial statements.
- Give opinions or disclaimers of opinion on the opinion units in the primary government's financial statements.

16.56 If the government has not also issued audited financial statements for the reporting entity, the auditor's report on separate primary government basic financial statements should express opinions on the opinion units that are presented and express an adverse opinion on the missing aggregate discretely

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[17] Individual fund and departmental, agency, and program financial statements are discussed in paragraphs 16.87–.91.

presented component unit opinion unit.[18] If the reporting entity financial statements would have included blended component units, the auditor should consider expressing a modified opinion on the opinion units that would have presented those blended component units, as discussed in paragraph 16.57. Appendix A (example A-13) illustrates a report on the basic financial statements of a primary government that omits the financial data of each component unit and that does not issue audited financial statements for the reporting entity.

16.57 Governments sometimes present financial statements that omit the financial information of one or more (but not all) component units. The auditor's response depends on the materiality of the omission in relation to the relevant opinion unit(s). When an omitted component unit should have been presented as a blended component unit, the auditor considers whether the omitted component unit would have been presented as a major fund or instead as a part of the opinion unit that includes the aggregate remaining fund information and considers quantitative and qualitative factors in evaluating the materiality of the omission in the context of the relevant opinion unit. When the omitted component unit is fiduciary in nature, the auditor considers the omission within the context of the opinion unit that includes the aggregate remaining fund information. When the omitted component unit should have been discretely presented, the auditor considers the omission within the context of the opinion unit that includes the aggregate discretely presented component units.

Component Unit Financial Statements

16.58 GASB Statement No. 14 paragraph 65 indicates that a component unit of a financial reporting entity may issue separate financial statements. Component units often issue separate financial statements, for example, to use in an official statement for the sale of component unit debt. GASB Statement No. 14 requires separately issued component unit financial statements to acknowledge that the entity is a component unit of another government and to disclose in the notes to the financial statements the primary government in whose financial reporting entity it is included and describe its relationship with the primary government. The auditors' report also should disclose that the entity is a component unit of a financial reporting entity. See the language used in the introductory paragraph of the illustrative auditor's report in appendix A (example A-2).

Adoption of New Accounting Principles by Component Units

16.59 Component units may be required or elect to adopt accounting and financial reporting principles arising from new GASB standards earlier than their primary governments. Paragraph .08 of AU-C section 706 explains the need for an emphasis-of-matter paragraph when an entity has changed accounting principles that have a material effect on the comparability of the entity's financial statements. The reporting entity's auditor should consider the effect of a component unit's change in accounting principles on the auditor's report on the reporting entity, based on the materiality of the change in accounting principles to the opinion unit in which the component unit is reported.

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[18] Instead of an adverse opinion, circumstances may require that the auditor express a disclaimer of opinion on the missing aggregate discretely presented component unit opinion unit because of a scope limitation. That would be the situation if the auditor cannot obtain appropriate information about the potential component units to evaluate whether they meet GASB standards for inclusion as component units.

More-Detailed Materiality Levels

16.60 The terms of an audit engagement may require the auditor to set the scope of the audit and assess materiality at a more-detailed level than at the opinion unit level used for the basic financial statements (for example, at an individual fund- or fund-type level). Chapter 4 explains that a more-detailed audit scope supplements, rather than replaces, the scope of the audit on a government's basic financial statements.

16.61 In some situations, the financial statements that are subject to the more-detailed audit scope are reported separately in the government's basic financial statements. In that situation, the auditor should report on the more-detailed audit in terms of the presentation of the subject financial statements as part of the basic financial statements. For example, GASB Statement No. 67, *Financial Reporting for Pension Plans—an amendment of GASB Statement No. 25*, requires the basic financial statements of a PERS with more than one defined benefit pension plan to display a statement of fiduciary net position and a statement of changes in fiduciary net position for each plan that is administered by a trust or equivalent arrangement that meets specified criteria. (Chapter 13, "Defined Benefit Pension Plans: Pension Plans (Plan & Employer Considerations)" describes the accounting and financial reporting for pension plans that are administered through trusts that meet specified criteria.) The auditor engaged to audit the financial statements of each plan should report on that more-detailed audit scope by referring to the presentation in the basic financial statements. Appendix A (example A-14) provides an illustrative auditor's report when the auditor has been engaged to audit the aggregate nonmajor governmental funds, the aggregate nonmajor enterprise funds, the internal service fund type, and each fiduciary fund type that comprise the basic financial statements' aggregate remaining fund information opinion unit.

16.62 In other situations, the financial statements that are subject to the more-detailed audit scope are not reported separately in the basic financial statements. In that situation, the auditor should report on the more-detailed audit in terms of the presentation of the subject financial statements outside of the basic financial statements as SI. This would involve, for example, the financial statements for a nonmajor enterprise fund that are aggregated in the basic financial statements with other nonmajor enterprise funds. Appendix A (example A-15) provides an illustrative auditor's report when the auditor has been engaged to audit each fund in a government's combining and individual fund financial statements. See the further discussion in this regard in paragraph 16.65.

Required Supplementary Information, Supplementary Information, and Other Information

16.63 A government usually presents its basic financial statements in a document that includes various financial, statistical, and other information presented outside the basic financial statements. As discussed in chapter 2, GAAP specify that certain information be presented as RSI. RSI required by GASB is MD&A and certain budgetary comparison information, pension, and postemployment benefit other than pension information, risk financing, and capital asset condition assessment information, if applicable. Governments may voluntarily provide "GASB defined" SI to supplement and expand upon the basic financial statements. Depending on the type of information and engagement, "GASB defined" SI may be considered SI under AU-C section 725, or OI under AU-C section 720. Further, some governments provide SI, OI or both as part of a CAFR, which is required to contain certain elements—an introductory section, appropriate combining and individual fund financial statements and schedules, and a statistical section. Chapter 2 provides an overview of the basic financial statements and RSI required by GASB standards and discusses "GASB defined" SI that often accompanies the basic financial statements. The auditor's responsibility for performing procedures on RSI, SI, and OI is discussed in chapter 4.

16.64 Unless the auditor is engaged to audit information that accompanies the basic financial statements as discussed in paragraph 16.65,[19] the manner in which the auditor reports on that information depends on whether it is RSI; SI (that is, the auditor is engaged to report on SI in relation to the financial statements as a whole); or OI. Paragraphs 16.66–.73 discuss reporting on RSI; paragraphs 16.74–.79 discuss reporting on SI in relation to the financial statements as a whole, and paragraphs 16.80–.84 discuss reporting on OI. Paragraph 16.85 discusses the effect on the group auditor's report of a component auditor's work on RSI and SI, and paragraph 16.86 discusses certain issues relating to reporting on prior-year SI.

Audit Scope Includes Required Supplementary Information, Supplementary Information, or Other Information

16.65 The auditor may be engaged to audit RSI, "GASB defined" SI, or a combination thereof—that is, express an opinion whether the information is fairly presented, in all material respects, in accordance with GAAP. For example, if the government elects to present the required budgetary comparisons (RSI) as a basic financial statement, then the auditor applies AU-C section 700. If the auditor is engaged to audit the combining and individual fund financial presentations ("GASB defined" SI) accompanying the basic financial statements, then AU-C section 805, *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement* (AICPA, *Professional Standards*), applies. Chapter 4 discusses auditor considerations in accepting such an engagement. When engaged to express an opinion on RSI or "GASB defined" SI, the auditor establishes materiality for planning, performing, evaluating the results of, and reporting on the results of the audit depending on the terms of the engagement. Appendix A (example A-15) illustrates an auditor's report when the engagement terms provide for the audit of each fund presented as "GASB defined" SI in combining and individual nonmajor governmental, nonmajor enterprise, internal service, and fiduciary fund financial statements.

Required Supplementary Information

16.66 The auditor's reporting on RSI is discussed in AU-C section 730. Although RSI is not a part of the basic financial statements, auditors are

[19] Being *engaged to audit* information that accompanies the basic financial statements means being engaged to express an opinion whether that accompanying information is fairly presented, in all material respects, in accordance with GAAP. Unless the auditor is engaged to audit the accompanying information, this guide refers to the information as *unaudited*, even though GAAS require the auditor to perform specific procedures, as discussed in chapter 4, and perhaps to report on the information, as discussed in this section of this chapter.

required to perform certain limited procedures on RSI[20] as discussed in chapter 4. RSI is an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. However, RSI is not considered essential to the fair presentation of the basic financial statements. Therefore, the omission of RSI or the presentation of RSI in a manner that does not meet the prescribed guidelines established by GAAP does not affect the auditor's conclusion regarding the fair presentation of the basic financial statements. In the prescribed guidelines for RSI, GAAP often require notes to RSI and specify the placement of RSI in relation to the basic financial statements. Those note and placement requirements are part of the prescribed guidelines. RSI and "GASB defined" SI normally are presented separately from each other to assist users to understand the nature of each. The auditor should consider whether RSI is sufficiently segregated from "GASB defined" SI.

16.67 Only information required to accompany an entity's basic financial statements can be considered RSI. All other information is considered "GASB defined" SI (that is, SI or OI) even though law, regulation, or resource contributors may require that such information accompany the basic financial statements. Further, the nature of RSI does not permit governments to voluntarily expand the contents of RSI. For example, as discussed in chapter 11, GASB Statement No. 34, as amended, requires a budgetary comparison schedule to be presented as RSI for the general fund and for each major special revenue fund that has a legally adopted annual budget. Budgetary comparison information for other funds, such as for nonmajor special revenue funds or for capital projects or debt service funds, may be presented as SI or OI, but not as RSI.

16.68 Paragraph .07 of AU-C section 730 states that the auditor should include an other-matter paragraph (after the opinion paragraph) in the auditor's report on the financial statements to refer to the RSI. The other-matter paragraph should include language to explain the following circumstances, as applicable:

- The RSI is included, and the auditor has applied the procedures in paragraph .05 of AU-C section 730 (discussed in chapter 4).
- The RSI is omitted.
- Some RSI is missing and some is presented in accordance with the prescribed guidelines.
- The auditor has identified material departures from the prescribed guidelines.
- The auditor is unable to complete the procedures in paragraph .05 of AU-C section 730.
- The auditor has unresolved doubts about whether the RSI is presented in accordance with prescribed guidelines.

16.69 Paragraph .08 of AU-C section 730 discusses the auditor's reporting responsibilities when all or some of the RSI is presented. In such circumstances, the auditor's other-matter paragraph should include the following elements:

- A statement that accounting principles generally accepted in the United States of America require that the RSI be presented to supplement the basic financial statements.

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[20] Unless the auditor is engaged to audit the RSI as described in chapter 4, the RSI is considered *unaudited*, even though GAAS require the auditor to perform specific procedures and to report on the information as discussed in this section.

- A statement that such information, although not a part of the basic financial statements, is required by GASB who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context.
- If the auditor is able to complete the procedures in paragraph .05 of AU-C section 730, paragraph .08*c* of AU-C section 730 states that the auditor's other-matter paragraph should include
  - — a statement that the auditor has applied certain limited procedures to the RSI in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to the auditor's inquiries, the basic financial statements, and other knowledge the auditor obtained during the audit of the basic financial statements.
  - — a statement that the auditor does not express an opinion or provide any assurance on the information because the limited procedures do not provide the auditor with sufficient evidence to express an opinion or provide any assurance.
- If the auditor is unable to complete the procedures required in paragraph .05 of AU-C section 730, paragraph .08*d* of AU-C section 730 states that the auditor's other-matter paragraph should include
  - — a statement that the auditor was unable to apply certain limited procedures to the RSI in accordance with auditing standards generally accepted in the United States because (*state the reasons*).
  - — a statement that the auditor does not express an opinion or provide any assurance on the information.
- If some of the RSI is omitted, the auditor's other-matter paragraph should include
  - — a statement that management has omitted (*description of the missing RSI*) that accounting principles generally accepted in the United States of America require to be presented to supplement the basic financial statements.
  - — a statement that such missing information, although not a part of the basic financial statements, is required by GASB, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context.
  - — a statement that the auditor's opinion on the basic financial statements is not affected by the missing information.
- If the measurement or presentation of the RSI departs materially from the prescribed guidelines, a statement that although the

auditor's opinion on the basic financial statements is not affected, material departures from prescribed guidelines exist (*describe the material departures from accounting principles generally accepted in the United States of America*).

- If the auditor has unresolved doubts about whether the RSI is measured or presented in accordance with prescribed guidelines, a statement that although the auditor's opinion on the basic financial statements is not affected, the results of the limited procedures have raised doubts about whether material modifications should be made to the RSI for it to be presented in accordance with guidelines established by GASB.

16.70 Paragraph .09 of AU-C section 730 discusses the auditor's reporting responsibilities when the RSI is omitted. In such circumstances, the other-matter paragraph should include the following elements:

- A statement that management has omitted the (*describe the missing RSI*) that accounting principles generally accepted in the United States of America require to be presented to supplement the basic financial statements
- A statement such missing information, although not a part of the basic financial statements, is required by GASB who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context
- A statement that the auditor's opinion on the basic financial statements is not affected by the missing information

16.71 Paragraph .A3 of AU-C section 730 provides an exhibit of example language for other-matter paragraphs related to a number of various scenarios the auditor might encounter in the audit of a governmental entity. An example of an other-matter paragraph if RSI is included, the auditor has applied specified procedures, and no material departures from prescribed guidelines have been identified is as follows:

> ***Other Matter***
>
> *Required Supplementary Information*
>
> Accounting principles generally accepted in the United States of America, require that the management's discussion and analysis on pages XX–XX and the budgetary comparison information on pages XX and XX be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's response to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not

provide us with sufficient evidence to express an opinion or provide any assurance.

When a portion of the RSI is omitted (for example, the required budgetary comparison information),[21] the following other-matter paragraphs should be added:

Accounting principles generally accepted in the United States of America, require that the management's discussion and analysis on pages XX–XX be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's response to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Management has omitted the budgetary comparison information for the [*indicate the funds for which information is omitted*] that accounting principles generally accepted in the United States of America require to be presented to supplement the basic financial statements. Such missing information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of the financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. Our opinion on the basic financial statements is not affected by this missing information.

When all RSI (for example, management's discussion and analysis and the budgetary comparison) is omitted, the following other-matter paragraph should be added:

Management has omitted management's discussion and analysis and the budgetary comparison [*indicate the funds for which information is omitted*] information that accounting principles generally accepted in the United States of America require to be presented to supplement the basic financial statements. Such missing information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of the financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context.

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[21] If all of the required budgetary comparison information is omitted or if only part of the required budgetary comparison information is presented as RSI, the omission of required budgetary comparison information is an omission of RSI. If, however, the government chooses to present required budgetary comparison information as a basic financial statement and presents only part of the required information, the omission constitutes a departure from GAAP in the basic financial statements that the auditor should consider in evaluating his or her opinions on the opinion units for which budgetary presentations are required but not made.

Our opinion on the basic financial statements is not affected by this missing information.

16.72 Paragraph .A3 of AU-C section 730 also provides illustrative wording for the following scenarios: material departures from prescribed guidelines, specified procedures not completed, and unresolved doubts about whether the RSI is in accordance with prescribed guidelines.

16.73 The following are examples of other situations regarding RSI the auditor might encounter:

- In certain circumstances, a budget is not adopted for the general or a major special revenue fund because it is not legally required and, therefore, presentation of budgetary comparison information is not required. Although that situation should not result in the auditor reporting that RSI has been omitted, it should be disclosed in the notes to RSI to explain why what might appear to be required information is not part of the presentation. If the government chooses to present its required budgetary comparison information in the basic financial statements, this disclosure should be made in the notes to the financial statements.
- If a government does not present RSI relating to infrastructure assets accounted for using the modified approach, that omission does not affect the government's ability to apply the modified approach to infrastructure assets in its basic financial statements. However, the entity should meet the conditions required to use the modified approach, as discussed in chapter 7, and the auditor should include an other-matter paragraph describing the omitted RSI (See paragraph 16.70).
- If a government provides comparative prior-year financial statements, question 7.5.4 of the IG 2015-1 states that MD&A is required to address both years presented in the comparative financial statements. The comparative MD&A would include comparative condensed financial information and related analysis for both years. (That, is, the MD&A should provide data so that each of the two years presented in the comparative financial statements can be compared to its prior year, meaning that there should be three years of comparative data—the current year, the prior year, and the year preceding the prior year.) If the data for the year preceding the prior year is omitted, the auditor should include an other-matter paragraph describing the omitted RSI.

Supplementary Information

16.74 The auditor's reporting on SI is described in AU-C section 725. If an auditor is engaged to report on whether SI is fairly stated in all material respects in relation to the financial statements as whole, certain procedures on SI[22] are required to be performed, as discussed in chapter 4. An opinion on whether SI is fairly stated in all material respects is made in relation to the

[22] *Unaudited SI* is information that accompanies the basic financial statements on which the auditor is not engaged to express an opinion whether it is fairly presented in accordance with GAAP. Unless the auditor is engaged to audit the SI, this guide refers to the information as *unaudited*, even though GAAS require the auditor to perform specific procedures, as discussed in chapter 4, and perhaps to report on the information, as discussed in this section of this chapter.

basic financial statements as a whole, not in relation to any of the individual opinion units. An "in relation to" opinion is possible because the audit of the basic financial statements encompasses the information presented in the SI. If the auditor concludes, on the basis of the procedures performed, that the SI is materially misstated in relation to the financial statements as a whole, the auditor should discuss the matter with management and propose appropriate revision of the SI. If management does not revise the SI appropriately, the auditor should either (*a*) modify his or her opinion on the SI and describe the misstatement in the auditor's audit report or (*b*) if a separate report on SI is being issued, withhold the auditor's report on the SI. Paragraph 16.79 discusses reporting responsibilities in these circumstances.

16.75 SI may be presented in a document containing the audited financial statements or separate from the audited financial statements. Information related to the auditor's responsibilities for SI that is presented separately from the financial statements is discussed in paragraphs .10 and .A16 of AU-C section 725.

16.76 The date of the auditor's report on SI in relation to the financial statements as a whole should not be dated earlier than the date on which the auditor completed the procedures required in paragraph .12 of AU-C section 725 (see chapter 4). When the auditor completes the procedures under AU-C section 725 subsequent to the date of the auditor's report on the basic financial statements, the auditor is not required to obtain additional evidence with respect to the audited financial statements. AU-C section 9725, *Supplementary Information in Relation to the Financial Statements as a Whole: Auditing Interpretations of Section 725* (AICPA, *Professional Standards*), provides that, although not required, an auditor may (*a*) when issuing a separate report on the SI, include in such report a statement that the auditor has not performed any auditing procedures with respect to the audited financial statements subsequent to the date of the auditor's report on those audited financial statements or (*b*) when reissuing a report on the audited financial statements to include an other-matter paragraph to report on the SI, include two report dates to indicate that the date of reporting on the SI is as of a later date.

16.77 When reporting on SI that is presented with the entity's financial statements, the auditor should report on SI in either (*a*) an other-matter paragraph following the opinion paragraph in the auditor's report on the financial statements or (*b*) in a separate report on SI. Contents of the other-matter paragraph are discussed in paragraph .09 of AU-C section 725 and are included as follows:

- A statement that the
  - — audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the government's financial statements as a whole.
  - — SI is presented for purposes of additional analysis and is not a required part of the basic financial statements.
  - — SI is the responsibility of management and was derived from, and relates directly to, the underlying accounting and other records used to prepare the financial statements.

    - SI has been subjected to the auditing procedures applied in the audit of the basic financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the basic financial statements or to the basic financial statements themselves and other additional procedures, in accordance with auditing standards generally accepted in the United States of America.

- If the auditor issues an unmodified opinion on the basic financial statements and the auditor has concluded the SI is fairly stated, in all material respects, in relation to the financial statements as a whole, a statement that, in the auditor's opinion, the SI is fairly stated, in all material respects, in relation to the basic financial statements as a whole.
- If the auditor issues a qualified opinion on the basic financial statements and the qualification has an effect on the SI, a statement that, in the auditor's opinion, except for the effects on the SI of (refer to the paragraph in the auditor's report explaining the qualification), such information is fairly stated, in all material, respects, in relation to the basic financial statements as a whole.
- When the audited financial statements are not presented with the SI, the auditor should report on the SI in a separate report. When reporting separately on the SI, the report should include, in addition to the elements noted previously, a reference to the report on the financial statements, the date of that report, the nature of the opinion expressed on the financial statements, and any report modifications. It is important to note that if a separate report is issued, management has the responsibility to make the audited financial statements readily available to the intended users of the SI no later than the date of issuance by the entity of the SI (as discussed in chapter 4) and the auditor's report thereon.

16.78 When the auditor's report on the audited basic financial statements contains an adverse opinion or a disclaimer of opinion and the auditor has been engaged to report on whether SI is fairly stated, in all material respects, in relation to such financial statements as a whole, the auditor is precluded from expressing an opinion on the SI. When permitted by law or regulation, the auditor may withdraw from the engagement to report on the SI. If the auditor does not withdraw, the auditor's report on the SI should state that because of the significance of the matter disclosed in the auditor's report, it is inappropriate to, and the auditor does not, express an opinion on the SI.

16.79 If the auditor concludes, on the basis of the procedures performed, that the SI is materially misstated in relation to the financial statements as a whole, the auditor should discuss the matter with management and propose appropriate revision of the SI. If management does not revise the SI, the auditor should either

- modify the auditor's opinion on the SI and describe the misstatement in the auditor's report or
- if a separate report on the SI is being issued, withhold the auditor's report on the SI.

Other Information

16.80 The auditor's reporting on OI is described in AU-C section 720. Although OI is not a part of the basic financial statements, auditors are required to perform certain procedures on OI[23] as discussed in chapter 4. In the absence of any separate requirement in the particular circumstance of the engagement, the auditor's opinion on the financial statements does not cover OI, and the auditor has no responsibility for determining whether such information is properly stated. Instead, the auditor's responsibility is to read the other information of which the auditor is aware because the credibility of the audited financial statements may be undermined by material inconsistencies between the audited financial statements and other information. If, on reading the other information, the auditor identifies a material inconsistency, the auditor should determine whether the audited financial statements or the other information needs to be revised.

16.81 When the auditor identifies a material inconsistency in the OI that requires revision of the audited basic financial statements, the auditor requirements depend upon when the material inconsistency was identified and management's actions:

- If identified prior to the report release date and management makes the appropriate revision, the auditor's opinion on the financial statements would not be impacted.
- If identified prior to the report release date and management refuses to make the appropriate revision, the auditor should modify the auditor's financial statement opinion in accordance with AU-C section 705.

If identified subsequent to the report release date, the auditor should apply the relevant requirements in AU-C section 560.

16.82 When the auditor identifies a material inconsistency in the OI that requires revision of the OI, the auditor requirements depend upon when the material inconsistency was identified and management's actions. If a material inconsistency is identified prior to the report release date and management refuses to make the appropriate revision, the auditor should communicate this matter to those charged with governance and in accordance with paragraph .12 of AU-C section 720

- include in the auditor's report on the audited financial statements an other-matter paragraph describing the material inconsistency;
- withhold the auditor's report; or
- when withdrawal is possible under applicable law or regulation, withdraw from the engagement. (In audits of governmental entities, withdrawal from the engagement or withholding the auditor's report may not be options. In such cases, the auditor may issue a report to those charged with governance and the appropriate statutory body, if applicable, giving details of the inconsistency.)

[23] Unless the auditor is engaged to audit the OI, this guide refers to the information as *unaudited*, even though GAAS require the auditor to perform specific procedures, as discussed in chapter 4, and perhaps to report on the information, as discussed in this section of this chapter.

When the auditor identifies a material inconsistency in the OI subsequent to the report release date and management agrees to make the appropriate revision, the auditor should carry out the procedures necessary under the circumstances.

16.83 If a material inconsistency is identified subsequent to the report release date and management refuses to make the appropriate revision, the auditor should notify those charged with governance of the auditor's concerns regarding the OI and take any further appropriate action, such as obtaining advice from the auditor's legal counsel.

16.84 If the auditor becomes aware of an apparent material misstatement of fact in the OI, the auditor should discuss the matter with management. After such discussions, if the auditor still considers that there is an apparent material misstatement of fact, the auditor should request management to consult with a qualified third party, such as the government's legal counsel, and the auditor should consider the advice received by the government in determining whether such matter is a material misstatement of fact. When the auditor concludes there is a material misstatement of fact that management refuses to correct, the auditor should notify those charged with governance of the auditor's concerns regarding the OI and take any further appropriate action.

Effect of a Component Auditor

16.85 Governmental financial statements often are accompanied by RSI and SI relating to a portion of the reporting entity, usually component units, whose financial statements were audited by a component auditor. In those situations, the auditor of the group financial statements should follow GAAS in deciding whether to perform required procedures on that information or, instead, to rely on the work of the component auditor. If the auditor of the group financial statements performs the required procedures, the discussion earlier in this section applies. If the auditor of the group financial statements decides instead to rely on the work of the component auditor, the auditor needs to determine if the component auditor's report addressed the applicable RSI or SI, if the auditor can rely on and whether to refer to the work of the component auditor, and then decide how to report that reference, as provided in AU-C section 600. Appendix A (example A-9) illustrates paragraphs that report on RSI and SI based in part on the report of a component auditor and that refer to the work of component auditors.

"In Relation to" Reporting on Prior-Year SI When Prior-Year Financial Statements Are Not Presented

16.86 Often, SI includes prior-year information. For example, combining and individual fund financial statements presented as SI may include data for two or more years. When prior-year SI is presented, the auditor may be engaged to express an opinion on whether all or certain of the prior year SI is fairly stated in all material respects in relation to the basic financial statements as a whole. The following discusses considerations for expressing an "in relation to" opinion on prior-year SI that accompanies the current-year financial statements when the basic financial statements for the prior year are not also presented in the financial report.

- If a continuing auditor subjected the prior-year SI to the auditing procedures applied in the audit of the prior year, as well as if the auditor was engaged to perform the additional procedures required in AU-C section 725, the auditor is able to express an "in relation to" opinion on that information. In expressing that opinion in the current-year report, the auditor's report should include a statement that the prior-year basic financial statements are not included in the current-year presentation, the date of the auditor's report on the prior-year financial statements, and the types of opinions expressed on those prior-year financial statements. For example, the other-matter paragraph for SI as shown in the illustrative auditor's report in appendix A (example A-1) could read as follows:

> ***Other Matter***
>
> *Other Information*
>
> Our audit for the year ended June 30, 20X1 was conducted for the purpose of forming opinions on the financial statements that collectively comprise the City of Example's basic financial statements. The [*identify accompanying supplementary information, such as the combining and individual nonmajor fund financial statements*] for the year ended June 30, 20X1 are presented for purposes of additional analysis and are not a required part of the basic financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the basic financial statements. The [*identify accompanying supplementary information*] have been subjected to the auditing procedures applied in the audits of the basic financial statements for the year ended June 30, 20X1, and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the basic financial statements or to the basic financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the [*identify accompanying supplementary information*] is fairly stated in all material respects in relation to the basic financial statements as a whole for the year ended June 30, 20X1.
>
> We also previously audited, in accordance with auditing standards generally accepted in the United States of America, the basic financial statements of City of Example as of and for the year ended June 30, 20PY (not presented herein), and have issued our report thereon dated September 15, 20PY, which contained unmodified opinions on the respective financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information. The [*identify accompanying supplementary information, such as the combining and individual nonmajor fund financial statements*] for the year ended June 30, 20PY is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information is the responsibility of management and was derived

from and relates directly to the underlying accounting and other records used to prepare the 20PY financial statements. The [*identify accompanying supplementary information*] have been subjected to the auditing procedures applied in the audit of the 20PY basic financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare those financial statements or to those financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the [*identify accompanying supplementary information*] is fairly stated in all material respects in relation to the basic financial statements as a whole for the year ended June 30, 20PY.

- If a predecessor auditor audited the basic financial statements in the years for which the prior-year SI is presented, and that auditor subjected the prior-year SI to the auditing procedures in AU-C section 725, in the prior year and expressed an "in relation to" opinion on that SI, the successor auditor is able to refer to that opinion. In the current-year report, the successor auditor should include statements that the prior-year basic financial statements are not included in the current-year presentation and that those financial statements were audited by another auditor, the date of the predecessor auditor's report, and the types of opinions expressed on those prior-year financial statements and on the SI. For example, the other-matter paragraph for SI as shown in the illustrative auditor's report in appendix A (example A-1) could read as follows:

Other Matter

Other Information

Our audit for the year ended June 30, 20X1 was conducted for the purpose of forming opinions on the financial statements that collectively comprise the City of Example's basic financial statements. The [*identify accompanying supplementary information, such as the combining and individual nonmajor fund financial statements*] for the year ended June 30, 20X1 is presented for purposes of additional analysis and are not a required part of the basic financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the basic financial statements. The [*identify accompanying supplementary information*] have been subjected to the auditing procedures applied in the audits of the financial statements for the year ended June 30, 20X1 and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the basic financial statements or to the basic financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the [*identify accompanying supplementary information*] is fairly stated in all material respects in relation to the basic financial statements as a whole for the year ended June 30, 20X1.

The City of Example's basic financial statements for the year ended June 30, 20PY (not presented herein), were audited by other auditors whose report thereon dated September 15, 20PY, expressed unmodified opinions on the respective financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information. The report of the other auditors dated September 15, 20PY, stated that the [*identify accompanying supplementary information, such as the combining and individual nonmajor fund financial statements*] for the year ended June 30, 20PY was subjected to the auditing procedures applied in the audit of the 20PY basic financial statements and certain additional auditing procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare those basic financial statements or the those basic financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America and, in their opinion, was fairly stated in all material respects in relation to the basic financial statements as a whole for the year ended June 30, 20PY.

Other Financial Presentations

Individual Fund Financial Statements

16.87 Many entities issue separate GAAP-based financial statements for one or more individual funds, for example, to use in an official statement for the sale of enterprise fund revenue bonds. Financial statements for one or more individual funds are intended to represent the specific fund(s) and not the overall government, and the financial statements normally follow the requirements established for fund financial statements and do not include government-wide financial statements. In developing an opinion on financial statements for one or more individual funds, the auditor considers GAAP to the extent those principles apply to the fund financial statements. Although GASB standards do not address the accounting and financial reporting for separately issued GAAP-based financial statements for one or more individual funds,[24] in meeting their reporting obligations, auditors should consider long-established practice dictating that those presentations should apply all relevant GAAP. Thus, in developing an opinion on the separately issued GAAP-based financial statements for one or more individual funds, the auditor considers whether the financial statements include all relevant GAAP financial statements, note disclosures, MD&A topics, and other RSI topics. Because the presentations are equivalent to the presentation of major fund financial statements, the auditor should plan, perform, evaluate the results of, and report on the audit based on each fund as a separate opinion unit.

[24] Accordingly, GASB did not clear the provisions set forth in this paragraph.

16.88 The introductory and opinion paragraphs of the auditor's report on an audit of fund financial statements should indicate the specific fund(s). The report also should include an emphasis-of-matter paragraph indicating that the financial statements do not purport to, and do not, present the government's financial position, changes in financial position, or, where applicable, cash flows. See the illustrative auditor's report in appendix A (example A-16).

16.89 Auditors may be asked to issue a separate report on individual fund financial statements that are covered by the audit of the government's audited basic financial statements. Because of the focus of an audit of a government's basic financial statements on opinion units, audit procedures on the basic financial statements of an overall government may or may not be adequate to support an opinion on an individual fund's financial statements. For example, those audit procedures might not be adequate if the fund is a nonmajor fund in the government's basic financial statements and thus part of the aggregate remaining fund information opinion unit. In that situation, the auditor may need to perform additional audit procedures to support the opinion on the individual fund. However, if the fund is a major fund in the government's basic financial statements, it is likely that additional procedures will not be needed to support the auditor's opinion on the individual fund financial statements.

16.90 When financial statements present only individual fund(s), the auditor should evaluate the extent to which the resulting presentation may be misleading to financial statement users who might misunderstand that the financial statements are meant to represent the overall government. For example, if a government presents a complete set of fund financial statements, that results in a misleading presentation and, as discussed in paragraph 16.10, the auditor should express an adverse opinion on the financial statements as a whole. Financial statements that include more than one fund are more likely to result in a misleading presentation. The point at which financial statements for more than one fund move from being an acceptable presentation of individual fund financial information to an incomplete presentation of the overall government is a matter of professional judgment considering in part what the financial statements purport to represent.

Departmental, Agency, and Program Financial Statements

16.91 Many entities, particularly state governments, issue separate GAAP-based financial statements for the government's departments, agencies, or programs.[25,26] (This paragraph uses the term *department* to refer to departments, agencies, and programs.) Although GASB standards do not address the accounting and financial reporting for separately issued GAAP-based departmental financial statements,[27] in meeting their reporting obligations, auditors should consider long-established practice dictating that those presentations should apply all relevant GAAP. Thus, in developing an opinion on separately

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[25] When an organizational unit is coterminous with a single fund, it is appropriate to issue a fund financial statement, as discussed in paragraphs 16.87–.90, rather than a departmental financial statement.

[26] Some reasons separate departmental audits may be conducted include: there may be legal or contractual provisions for certain departments to be separately audited; the department may be a separate accountability center; the separate audits may be part of a series of audits subject to Title 2 U.S. *Code of Federal Regulations* Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards*; or separate audits may be an efficient way to plan and execute the work for the audit of the overall government's financial statements.

[27] Accordingly, GASB did not clear the provisions set forth in this paragraph.

issued GAAP-based departmental financial statements, the auditor considers whether the financial statements include all relevant GAAP financial statements, note disclosures, MD&A topics, and other RSI topics. The auditor should plan, perform, evaluate the results of, and report on the audit based on the involved opinion units. The introductory and opinion paragraphs of the auditor's report on an audit of departmental financial statements should indicate the department. The report also should include an emphasis-of-matter paragraph that indicates the financial statements do not purport to, and do not, present fairly the government's financial position, changes in financial position, or, where applicable, cash flows. See the illustrative auditor's report in appendix A (example A-17).

Special-Purpose Regulatory Presentations

16.92 Law or regulation may require governments to prepare and file with a regulatory agency financial statements that do not constitute a complete presentation of all the financial statements required by GASB Statement No. 34, as amended, but that otherwise are prepared in accordance with GAAP.[28] For example, state regulations may require that a county prepare and file with a state agency fund financial statements for each separately elected county official, and specify that those financial statements be prepared using GAAP measurements, presentations, and disclosures. In those situations, paragraph .24 of AU-C section 805 states than when the auditor reports on an incomplete presentation but one that is otherwise in accordance with GAAP, the auditor should include an emphasis-of-matter paragraph in the auditor's report that

a. states the purpose for which the presentation is prepared and refers to a note in the financial statements that describes the basis of presentation and

b. indicates that the presentation is not intended to be a complete presentation of the government's assets, liabilities, revenues, or expenses.

The auditor should make materiality determinations for purposes of planning, performing, evaluating the results of, and reporting on the audits of such special-purpose presentations in a manner consistent with the requirements of the presentation and with the concept of opinion units as discussed in chapters 4 and 13 and elsewhere in this chapter. However, if the presentation is prepared in accordance with a regulatory or contractual basis of accounting, the requirements in paragraph .24 of AU-C section 805 do not apply, and the auditor should follow the guidance in AU-C section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks* (AICPA, *Professional Standards*). (See further discussion in chapter 17, "Financial Statements Prepared in Accordance With a Special-Purpose Framework.")

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[28] Other paragraphs in this chapter discuss the auditor's reports on financial statements for the primary government only (paragraphs 16.54–.57), an individual component unit (paragraph 16.58), individual funds (paragraphs 16.87–.90), and departments, agencies, and programs (paragraph 16.91). The provisions of those paragraphs apply to those financial presentations, even if those presentations are required by law or regulation, unless the law, regulation, or terms of the audit engagement require the auditor to issue a report using the provisions of paragraphs .22–.23 of AU-C section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks* (AICPA, *Professional Standards*).

Summary Financial Information

16.93 Some governments issue *popular reports*, directed primarily to citizens, which contain highly condensed summary financial information with accompanying notes to those financial statements. Paragraph 175 of National Council on Governmental Accounting Statement 1, *Governmental Accounting and Financial Reporting Principles*, as amended, requires that condensed summary financial statements supplement, rather than replace, the CAFR and the separately issued basic financial statements. That standard also requires that the data in those summary financial statements be reconcilable with the government's basic financial statements and refer the reader to the government's CAFR or basic financial statements.

16.94 AU-C section 810, *Engagements to Report on Summary Financial Statements* (AICPA, *Professional Standards*), provides guidance in reporting on condensed financial statements that are derived from audited financial statements of a public entity that is required to file, at least annually, complete audited financial statements with a regulatory agency. Because a government is not a public entity as defined under AU-C section 810 with respect to reporting on separately issued summary financial information, the provisions of AU-C section 810 do not apply to governments. The following paragraphs provide reporting guidance when an auditor of the basic financial statements is engaged to report on summary financial information issued by a government in a document that refers to, but does not include, the basic financial statements. The auditor may report on summary financial information only if the auditor has rendered an opinion on the government's basic financial statements and the auditor has not rendered a disclaimer of or adverse opinion on one of the opinion units from which the summary financial information was derived or on the basic financial statements as a whole. If a component auditor has been involved in rendering an opinion on the basic financial statements, only the auditor of the group financial statements may render the opinion on the summary financial information.

16.95 Summary financial information often differs in format and content from basic financial statements prepared in accordance with GAAP. Some governments include only their government-wide financial statements or only their fund financial statements (and related note disclosures) in their popular reports.[29] Other governments include either or both summarized government-wide and fund financial statements (and related note disclosures). That financial information may differ from GAAP in areas of summarization, aggregation, eliminations, inclusion of component units, or disclosure.

16.96 Governments should exercise discretion in preparing summary financial information for popular reports. At a minimum, the summary financial information should (*a*) be informative of matters that may affect its use, understanding, and interpretation (for example, the financial statements should be accompanied by notes that describe or should otherwise consider significant subsequent events, significant contingencies, or restrictions on resources), (*b*)

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[29] The guidance in this section only applies when the summary financial information supplements, rather than replaces, the comprehensive annual financial report (CAFR) or the separately issued basic financial statements and refers the reader to the government's CAFR or basic financial statements. If the government does not issue a CAFR or basic financial statements and presents only government-wide financial statements or only fund financial statements, the auditor should apply the guidance in paragraphs 16.10 and 16.35.

be prepared on the same measurement focus and basis of accounting as the relevant portion of the basic financial statements,[30] (*c*) be classified, summarized, and presented in a reasonable manner, and (*d*) reflect the underlying transactions and events in a manner that presents the summarized data within a range of acceptable limits, that is, limits that are reasonable and practicable to attain in summary financial information. The summary financial information should be clearly marked as such, and not as combined, consolidated, or condensed financial information, which users may relate to GAAP.

16.97 When the auditor has concluded that an unmodified opinion on the summary financial statements is appropriate, paragraph .14 of AU-C section 810 requires the auditor's opinion to state that the summary financial statements are consistent, in all material respects, with the audited financial statements from which they have been derived, in accordance with the criteria applied by management in the preparation of the summary financial statements. The auditor also should consider whether the summary financial information is fairly presented in accordance with the method of aggregation described in the notes to the summary financial information. Further, the auditor should consider whether the notes to the summary financial information disclose how the method of aggregation differs from the accounting policies used in preparing the basic financial statements, either through a numerical reconciliation or a narrative explanation and whether the notes refer the reader to the government's CAFR or basic financial statements.

16.98 Appendix A (example A-18) illustrates the auditor's report when the auditor concludes that summary financial information are consistent, in all material respects, with the audited financial statements from which they have been derived. The report should include the elements as discussed in AU-C section 810.

16.99 The issuance of a qualified opinion on one or more opinion units in the basic financial statements does not preclude the auditor from issuing a report on the summary financial information. Note, however, that an auditor is prohibited from issuing a report on summary financial information if the auditor rendered a disclaimer of or adverse opinion on one of the opinion units from which the summary financial information was derived or on the basic financial statements as a whole.

16.100 When the auditor's report on the summary financial statements is dated later than the date of the auditor's report on the audited financial statements, the auditor may become aware of *subsequently discovered facts* as defined in AU-C section 560. In such cases, the auditor should not release the auditor's report on the summary financial statements until the auditor's consideration of subsequently discovered facts in relation to the audited financial statements, in accordance with AU-C section 560, has been completed.

16.101 If a government issues summary financial information in a manner inconsistent with the guidance provided in paragraph 16.96 (for example, because the measurement focus and basis of accounting differs from that of the portion of the basic financial statements from which it has been

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[30] For example, if the summary financial information is related to the governmental funds, a current financial resources measurement focus and modified accrual basis of accounting should be used.

derived)[31] and management does not agree to make the necessary changes, the auditor should express an adverse opinion on the summary financial statements. The auditor should state in the opinion paragraph that, in the auditor's opinion, because of the significance of the matter(s) described in the basis for adverse opinion paragraph, the summary financial statements are not consistent, in all material respects, with the audited financial statements from which they have been derived, in accordance with the applied criteria.

16.102 When "GASB defined" SI accompanies summary financial information, the auditor's responsibility for and reporting on that information is the same as described in chapter 4 and earlier in this chapter. Because summary financial information is not presented in accordance with GAAP, GAAP requirements for RSI do not apply to those presentations. Therefore, any information that accompanies the summary financial information is considered, for auditing purposes, as SI or OI, depending on the nature of the information and the terms of the engagement.

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[31] A different measurement focus and basis of accounting would result, for example, from changing from a modified accrual basis of accounting to a cash basis or recording depreciation on general capital assets in an activity statement that is derived from the governmental fund statement of revenues, expenses, and changes in fund balances.

16.103

Appendix A—Illustrative Auditor's Reports

A-1 This appendix illustrates auditor's reports in specific situations discussed in this chapter. Auditors should modify the illustrative reports as needed in different situations, using selected elements of the illustrative reports where appropriate. The following list describes conditions that may make modifications necessary. Other conditions that may make modifications necessary are described in the footnotes to the illustrative reports:

- The illustrative auditor's reports cover a single year. Paragraphs 16.45–.51 discuss modifications to the auditor's report on the basic financial statements when those financial statements include information from a prior period.

- Within many of the illustrative auditor's reports there are references to both "basic financial statements" and "financial statements." There is an intended distinction for when each term is used because of the nature of governmental audits. That is, while the government prepares basic financial statements as defined by GASB (see chapter 2, "Financial Reporting," of this guide for a detailed description of the basic financial statements), the auditor expresses an opinion or disclaims an opinion on each opinion unit (see chapter 4, "General Auditing Considerations," and paragraphs 16.04–.11 for more information on opinion units). Therefore, when the term "financial statements" is used within the report illustrations it is generally a reference to the financial statements of each opinion unit.

- The auditor's report may need to separately name each individual major fund rather than refer to "each major fund." See paragraph 16.16.

- The introductory and opinion paragraphs should list only the opinion units presented in the financial statements. As discussed in paragraph 16.04, under certain circumstances, the auditor may choose to combine the two aggregate opinion units—the one for the aggregate discretely presented component units and the one for the aggregate remaining fund information—as a single opinion unit. If that is done, the terms *aggregate discretely presented component units* and *aggregate remaining fund information* should not be used in the auditor's report, for example, as shown in example A-1. Instead, the auditor's report should use the term *aggregate discretely presented component units and remaining fund information*.

- Illustrative auditor's reports on governmental financial statements conducted in accordance with the standards applicable to financial audits contained in *Government Auditing Standards* (also referred to as the Yellow Book), issued by the Comptroller General of the United States are discussed in detail in the AICPA Audit Guide Government Auditing Standards *and Single Audits*.

Footnote 2 to example A-1 provides the necessary modifications for such reporting.[1]

- If a government presents required budgetary comparison information as basic financial statements instead of as required supplementary information (RSI), the opinion paragraph should be modified to refer to the budgetary comparison in the manner shown in footnote 2.
- Based on the guidance in paragraphs .17–.22 of AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report* (AICPA, *Professional Standards*), a basis for modification paragraph should describe the matter giving rise to the qualified or adverse opinion on the financial position, changes in financial position, and, where applicable, cash flows for an opinion unit, and quantification of the financial effects of misstatements, unless impracticable. Paragraphs .18 and .A24 of AU-C section 705 describes when obtaining that information is practicable. If it is not practicable to quantify the effects, the auditor should so state in the basis for modification paragraph, as shown in other examples in this appendix.
- The opinion paragraph should refer to cash flows only if the financial statements are required to present one or more statements of cash flows. If only some opinion units are required to present statements of cash flows, the opinion paragraph should refer to "where applicable, cash flows."
- Because of the GASB requirement that financial statements be accompanied by management discussion and analysis, most governmental financial statements are required to present RSI. A government's financial statements also may be accompanied by supplementary information (SI), other information (OI), or both. Paragraphs 16.63–.84 discuss auditor reporting for RSI, SI, and OI. (See in particular the other-matter language in paragraph 16.68 if RSI is omitted and the discussion in paragraph 16.86 concerning an "in relation to" opinion on prior-year SI when prior-year financial statements are not presented.) Examples A-1 and A-9 illustrate auditor reporting on RSI and SI and assumes that the auditor is engaged to issue an "in relation to" opinion on SI. In addition, example A-15 illustrates unmodified opinions on combining and individual fund financial statements presented as "GASB defined" supplementary information.
- If prior-period financial information is a partial or summarized presentation (or a combination of partial and summarized information) and does not include the minimum information required by GAAP for a complete set of financial statements, modifications to the auditor's report are discussed in paragraphs 16.50–.51.

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[1] Specific guidance on reporting under Title 2 U.S. *Code of Federal Regulations* Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards*, referred to as the Uniform Guidance, can be found in the AICPA Audit Guide Government Auditing Standards *and Single Audits*.

A-2 The illustrative reports in this appendix are as follows:

Example A-1—Unmodified Opinions on Basic Financial Statements Accompanied by Required Supplementary Information and Other Information

Example A-2—Unmodified Opinion on the Basic Financial Statements of a Special-Purpose Government That Has a Single Opinion Unit

Example A-3—Unmodified Opinions on the Basic Financial Statements of a Special-Purpose Government That Has One Opinion Unit for the Primary Government and Another Opinion Unit for Its Aggregate Discretely Presented Component Units

Example A-4—Report on Basic Financial Statements That Includes a Qualified Opinion Because One (But Not All) Discretely Presented Component Units Are Not Audited

Example A-5—Report on Basic Financial Statements That Includes Qualified Opinions on Major Governmental Funds Because of a GAAP Departure

Example A-6—Report on Basic Financial Statements That Includes an Adverse Opinion on the Governmental Activities Because Certain General Infrastructure Assets Are Omitted

Example A-7—Report on Basic Financial Statements That Includes an Adverse Opinion on the Governmental Activities Because Compensated Absences Are Omitted

Example A-8—Report on Basic Financial Statements That Presents an Adverse Opinion on the Financial Statements as a Whole Because the Government-Wide Financial Statements Are Omitted

Example A-9—Unmodified Opinions on Basic Financial Statements Accompanied by Required Supplementary Information and Other Information With Reference to an Audit by Another Auditor

Example A-10—Report on Basic Financial Statements That Includes Multiple Opinion Modifications, Including an Adverse Opinion Because a Major Fund Is Omitted

Example A-11—Unmodified Opinions on the Basic Financial Statements of a Primary Government That Omits the Financial Data of Each Component Unit and That Issues Audited Financial Statements for the Reporting Entity

Example A-12—Report on Basic Financial Statements That Includes a Disclaimer of Opinion Because One (But Not All) Discretely Presented Component Unit Is Not Audited

Example A-13—Report on the Basic Financial Statements of a Primary Government That Omits the Financial Data of Each Component Unit and That Does Not Issue Audited Financial Statements for the Reporting Entity

Example A-14—Unmodified Opinions on Basic Financial Statements and on Additional Detail Presented in the Basic Financial Statements

Example A-15—Unmodified Opinions on Basic Financial Statements and on Combining and Individual Fund Financial Statements Presented as "GASB Defined" Supplementary Information

Example A-16—Unmodified Opinion on General Fund Financial Statements

Example A-17—Unmodified Opinions on Departmental Financial Statements

Example A-18—Report on Separately Issued Summary Financial Information

Example A-1

Unmodified Opinions on Basic Financial Statements Accompanied by Required Supplementary Information and Other Information

(Paragraphs 16.12–.16 and 16.66–.84)

Independent Auditor's Report

[*Appropriate Addressee*]

Report on the Financial Statements

We have audited the accompanying financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of and for the year ended June 30, 20X1, and the related notes to the financial statements, which collectively comprise the City's basic financial statements as listed in the table of contents.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express opinions on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America.[2] Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error.

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[2] When the audit is also performed under *Government Auditing Standards*, issued by the Comptroller General of the United States, the following modifications would be made to this report.

A. The second sentence of this section would be replaced with,

> We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

B. The final section of this illustrative report titled "Report on Other Legal and Regulatory Requirements" would be replaced with the following:

> **Other Reporting Required by *Government Auditing Standards***
> In accordance with *Government Auditing Standards*, we have also issued our report dated [*date of report*] on our consideration of the City of Example's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is solely to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the City of Example's internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering City of Example's internal control over financial reporting and compliance.

See the AICPA Audit Guide Government Auditing Standards *and Single Audits* for illustrations of the reporting required by *Government Auditing Standards* and other information on planning, performing and reporting on the audit in accordance with *Government Auditing Standards*.

In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

Opinions

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position, and, where applicable, cash flows thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.[3]

Other Matters[4]

Required Supplementary Information[5]

Accounting principles generally accepted in the United States of America require that the [*identify required supplementary information, such as management's discussion and analysis and budgetary comparison information*] on

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[3] If a government presents required budgetary comparison information as basic financial statements instead of as RSI, the opinion paragraph would be replaced with the following:

> In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position and, where applicable, cash flows thereof and the respective budgetary comparison for the [*indicate the major governmental funds involved*] for the year then ended in accordance with accounting principles generally accepted in the United States of America.

[4] The opening section of paragraph 16.103 of this chapter describes conditions that may make modifications to this report necessary, such as when the financial statements include information from a prior period or when the auditor is reporting on required supplementary information (RSI), supplementary information (SI), or other information (OI). See also footnotes 5, 6, and 7.

[5] This RSI paragraph, within the "Other Matters" section of the report illustrates a situation where RSI is included, the auditor has applied the specified procedures, and no material departures from prescribed guidelines have been identified.

If all of the RSI is omitted, the paragraph on RSI would be replaced with the following:

> Management has omitted [*identify the missing RSI, such as management's discussion and analysis or budgetary comparison information*] that accounting principles generally accepted in the United States of America require to be presented to supplement the basic financial statements. Such missing information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. Our opinion on the basic financial statements is not affected by this missing information.

For other situations in which some RSI is omitted and some is presented in accordance with prescribed guidelines, there are material departures from prescribed guidelines, specified procedures were not completed, or there are unresolved doubts about whether the RSI is in accordance with prescribed guidelines, refer to the guidance in AU-C section 730, *Required Supplementary Information* (AICPA, *Professional Standards*).

pages XX–XX and XX–XX be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Information[6,7]

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the City of Example's basic financial statements. The [*identify accompanying supplementary information, such as the combining and individual nonmajor fund financial statements, and the other information, such as the introductory and statistical sections*] are presented for purposes of additional analysis and are not a required part of the basic financial statements.

The [*identify accompanying supplementary information*] is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the basic financial statements or to the basic financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the [*identify accompanying supplementary information*] is fairly stated, in all material respects, in relation to the basic financial statements as a whole.

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[6] This section, within the "Other Matters" section of the report, is intended to include the reporting on SI when the auditor is engaged to provide an "in relation to" opinion on SI and also when explanatory language will be provided relating to OI when the auditor is disclaiming an opinion on the OI. This illustration provides example language for both SI and OI reporting. The caption provided in this illustration is one way an auditor could title the section. Alternatively, the auditor could title it "Supplementary and Other Information," "Supplementary Information," or "Accompanying Information."

[7] This illustration assumes that the auditor has been engaged to provide an "in-relation-to" opinion on SI, the auditor is issuing an unmodified opinion on the financial statements, and the auditor has concluded that the SI is fairly stated, in all material respects, in relation to the financial statements as a whole. If there is no SI on which to report, the references to SI in these paragraphs would be deleted. If the auditor has issued an opinion other than unmodified on the financial statements, see the guidance in AU-C section 725, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*). Additionally, the OI reporting contained within this section provides an example of explanatory language that the auditor may use to disclaim an opinion on OI. Note there is no required reporting on OI under AU-C section 720, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*). If there is no OI contained in the document containing the audited financial statements or if the auditor chooses not to include the disclaimer, the references to OI in this section would be deleted. See AU-C section 720 for more information.

The [*identify the other information*] has not been subjected to the auditing procedures applied in the audit of the basic financial statements, and accordingly, we do not express an opinion or provide any assurance on it.

Report on Other Legal and Regulatory Requirements[8]

[*Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities, if any.*]

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

[8] In some circumstances, the auditor may have additional responsibilities to report on other matters that are supplementary to the auditor's responsibility under generally accepted auditing standards. When there are such other reporting responsibilities, they should be addressed in a separate section in the auditor's report. The form and content of the "Other Reporting Responsibilities" section of the auditor's report are described in paragraph .37 of AU-C section 700, *Forming an Opinion and Reporting on Financial Statements* (AICPA, *Professional Standards*). Paragraph .37 of AU-C section 700 also provides that the section related to an auditor's other reporting responsibilities should be subtitled "Report on Other Legal and Regulatory Requirements" or otherwise, as appropriate to the content of the section. For example, if the audit is also performed in accordance with *Government Auditing Standards*, an alternative title would be "Other Reporting Required by *Government Auditing Standards*." See footnote 1.

Example A-2

Unmodified Opinion on the Basic Financial Statements of a Special-Purpose Government That Has a Single Opinion Unit

(Paragraphs 16.17 and 16.58)

Independent Auditor's Report

[*Appropriate Addressee*]

Report on the Financial Statements

We have audited the accompanying financial statements of the Example Component Unit (ECU), a component unit of the City of Example, Any State,[9] as of and for the year ended June 30, 20X1, and the related notes to the financial statements, which collectively comprise the ECU's basic financial statements as listed in the table of contents.

Management's Responsibility for the Financial Statements

[*Same paragraph as in example A-1*]

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America.[10] Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the ECU as of June 30, 20X1, and the changes in its financial position and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.[11]

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[9] As discussed in paragraph 16.58, the auditors' report should disclose that an entity is a component unit of a financial reporting entity. If the special-purpose government is not a component unit of another government, this reference to being a component unit should be removed.

[10] See footnote 2.

[11] In the opinion paragraph, the terms *financial position* and *changes in financial position* could be replaced with terms that would be more descriptive in the circumstances. For example, in a report on a public employee retirement system, the terms *plan net position or fiduciary net position* and *changes in plan net position or changes in fiduciary net position* might be used.

Other Matters[12]

[*See illustrative wording in example A-1 and related footnotes for circumstances involving RSI or OI*]

Report on Other Legal and Regulatory Requirements[13]

[*Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities, if any.*]

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

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[12] See footnote 4.

[13] See footnote 8.

Example A-3

Unmodified Opinions on the Basic Financial Statements of a Special-Purpose Government That Has One Opinion Unit for the Primary Government and Another Opinion Unit for Its Aggregate Discretely Presented Component Units

(Paragraph 16.17)

Independent Auditor's Report

[*Appropriate Addressee*]

Report on the Financial Statements

We have audited the accompanying financial statements of the business-type activities[14] and aggregate discretely presented component units of Example District, Any State, as of and for the year ended June 30, 20X1, and the related notes to the financial statements, which collectively comprise the District's basic financial statements as listed in the table of contents.

Management's Responsibility for the Financial Statements

[*Same paragraph as in example A-1*]

Auditor's Responsibility

[*Same paragraphs as in example A-1*]

Opinions

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the business-type activities and the aggregate discretely presented component units of the Example District, Any State, as of June 30, 20X1, and the respective changes in financial position and, where applicable, cash flows thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters[15]

[*See illustrative wording in example A-1 and related footnotes for circumstances involving RSI or OI*]

Report on Other Legal and Regulatory Requirements[16]

[*Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities, if any.*]

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

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[14] The example assumes that the special-purpose government is engaged only in business-type activities. If the special-purpose government is engaged only in fiduciary activities, the introductory and opinion paragraphs would refer to fiduciary activities.

[15] See footnote 4.

[16] See footnote 8.

Example A-4

Report on Basic Financial Statements That Includes a Qualified Opinion Because One (But Not All) Discretely Presented Component Unit Is Not Audited[17]

(Paragraph 16.28)

Independent Auditor's Report

[*Appropriate Addressee*]

Report on the Financial Statements

[*Same paragraph as in example A-1*]

Management's Responsibility for the Financial Statements

[*Same paragraph as in example A-1*]

Auditor's Responsibility

Our responsibility is to express opinions on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America.[18] Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our [*identity types of audit opinions provided, such as unmodified, qualified, or adverse*] audit opinions.

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[17] This example assumes that the auditor has concluded that the single unaudited component unit warrants a qualified opinion. Another auditor could make a different professional judgment. An example of a disclaimer of opinion is shown in example A-12 if the auditor was to conclude that a disclaimer of opinion on the aggregate discretely presented component units (but not on the financial statements as a whole) is appropriate.

[18] See footnote 2

Summary of Opinions[19]

Opinion Unit	*Type of Opinion*
Governmental Activities	Unmodified
Business-Type Activities	Unmodified
Aggregate Discretely Presented Component Units	Qualified
Governmental Fund X	Unmodified
Governmental Fund Y	Unmodified
Governmental Fund Z	Unmodified
Enterprise Fund A	Unmodified
Enterprise Fund B	Unmodified
Aggregate Remaining Fund Information	Unmodified

Basis for Qualified Opinion on the Aggregate Discretely Presented Component Units

The financial statements of Example Component Unit (ECU) have not been audited, and we were not engaged to audit the ECU financial statements as part of our audit of the City's basic financial statements. ECU's financial activities are included in the City's basic financial statements as a discretely presented component unit and represent XX percent, XX percent, and XX percent of the assets, net position, and revenues, respectively, of the City's aggregate discretely presented component units.[20]

Qualified Opinion

In our opinion, except for the possible effects of the matter described in the "Basis for Qualified Opinion on the Aggregate Discretely Presented Component Units" paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of the aggregate discretely presented component units of the City of Example, Any State, as of June 30, 20X1, and the changes in financial position thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Unmodified Opinions

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, each major fund, and the aggregate remaining

[19] This table is not a required element of the auditor's report under AU-C section 700. It is included here and in other illustrations in this section to illustrate an additional way for the auditor to communicate that more than one type of opinion is being issued. Its inclusion may assist users in more easily understanding the report.

[20] Based on the guidance in paragraphs .17–.22 of AU-C section 705, a basis for modification paragraph should describe the matter giving rise to the qualified or adverse opinion on the financial position, changes in financial position, and, where applicable, cash flows for an opinion unit and quantification of the financial effects of misstatements, unless impracticable. Paragraphs .18 and .A24 of AU-C section 705 describe when obtaining that information is practicable. If it is not practicable to quantify the effects, the auditor should so state in the basis for modification paragraph, as shown in other examples in this appendix.

fund information of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position and, where applicable, cash flows thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters[21]

[*See illustrative wording in example A-1 and related footnotes for circumstances involving RSI or OI*]

Report on Other Legal and Regulatory Requirements[22]

[*Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities if any.*]

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

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[21] See footnote 4.

[22] See footnote 8.

Example A-5

Report on Basic Financial Statements That Includes Qualified Opinions on Major Governmental Funds Because of a GAAP Departure[23]

(Paragraph 16.33)

Independent Auditor's Report

[*Appropriate Addressee*]

Report on the Financial Statements

[*Same paragraph as in example A-1*]

Management's Responsibility for the Financial Statements

[*Same paragraph as in example A-1*]

Auditor's Responsibility

[*Same paragraphs as in example A-4*]

Summary of Opinions[24]

Opinion Unit	*Type of Opinion*
Governmental Activities	Unmodified
Business-Type Activities	Unmodified
Aggregate Discretely Presented Component Units	Unmodified
Governmental Fund X	Qualified
Governmental Fund Y	Qualified
Governmental Fund Z	Unmodified
Enterprise Fund A	Unmodified
Enterprise Fund B	Unmodified
Aggregate Remaining Fund Information	Unmodified

Basis for Qualified Opinions on Major Governmental Funds X and Y[25]

Management has not adopted a methodology for reviewing the collectibility of taxes receivable in the [*identify the affected major governmental funds, such as Major Governmental Funds X and Y*] and, accordingly, has not considered the need to provide an allowance for uncollectible amounts. Accounting principles

[23] Depending on the nature and magnitude of the U.S. generally accepted accounting principles (GAAP) departure, it is possible that the auditor's opinion on the governmental activities also would be qualified, as illustrated in example A-10. Further, the same GAAP departure in the nonmajor governmental funds could affect the auditor's opinion on the aggregate remaining fund information. This example assumes that the auditor has concluded that the GAAP departure is not material to the governmental activities opinion unit or to the aggregate remaining fund information opinion unit. Another auditor could make a different professional judgment. (See paragraphs 16.07–.08.) If a GAAP departure is material to more than one opinion unit, the basis for modification paragraph should explain the nature and effect of the departure on each affected opinion unit.

[24] See footnote 19.

[25] As there are multiple opinion units provided in this report, the heading to this section illustrates identifying the opinion units to which the basis for opinion modifications apply to more clearly communicate the opinion units associated with the modification.

generally accepted in the United States of America require that an adequate allowance be provided for uncollectible receivables, which would decrease the assets and fund balances and change the revenues in the [*identify the affected major governmental funds*]. The amount by which this departure would affect the assets, fund balances, and revenues of the [*identify the affected major governmental funds*] has not been determined.[26,27]

Qualified Opinions

In our opinion, except for the effects of the matter described in the "Basis for Qualified Opinions on Major Governmental Funds X and Y" paragraph, the financial statements referred to above present fairly, in all material respects, the respective financial position of the [*identify the affected major governmental funds*] of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Unmodified Opinions

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, the aggregate discretely presented component units, [*identify the major funds not affected by the qualification*], and the aggregate remaining fund information of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position and, where applicable, cash flows thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters[28]

[*See illustrative wording in example A-1 and related footnotes for circumstances involving RSI or OI*]

Report on Other Legal and Regulatory Requirements[29]

[*Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities, if any.*]

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

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[26] If a government presents required budgetary comparison information as basic financial statements instead of as RSI, the basis for modification paragraph also should explain the effect of the GAAP departure on the budgetary comparison information. This example assumes that the government budgets on a cash basis, and thus the GAAP departure would not affect the budgetary comparison information if it were presented as a basic financial statement. Example A-1 provides modification that would be needed to this report in other areas if required budgetary comparison information is presented as a basic financial statement.

[27] See footnote 20.

[28] See footnote 4.

[29] See footnote 8.

Example A-6

Report on Basic Financial Statements That Includes an Adverse Opinion on the Governmental Activities Because Certain General Infrastructure Assets Are Omitted[30]

(Paragraph 16.34)

Independent Auditor's Report

[*Appropriate Addressee*]

Report on the Financial Statements

[*Same paragraph as in example A-1*]

Management's Responsibility for the Financial Statements

[*Same paragraph as in example A-1*]

Auditor's Responsibility

[*Same paragraphs as in example A-4*]

Summary of Opinions[31]

Opinion Unit	*Type of Opinion*
Governmental Activities	Adverse
Business-Type Activities	Unmodified
Aggregate Discretely Presented Component Units	Unmodified
Governmental Fund X	Unmodified
Governmental Fund Y	Unmodified
Governmental Fund Z	Unmodified
Enterprise Fund A	Unmodified
Enterprise Fund B	Unmodified
Aggregate Remaining Fund Information	Unmodified

Basis for Adverse Opinion on Governmental Activities

As discussed in Note X to the financial statements, management has not recorded certain general infrastructure assets in governmental activities and, accordingly, has not recorded depreciation expense on those assets. Accounting principles generally accepted in the United States of America require that those general infrastructure assets be capitalized and depreciated, which would increase the assets, net position, and expenses of the governmental activities.

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[30] As discussed in paragraph 16.34, an adverse opinion usually would be appropriate if a general-purpose government omits general infrastructure assets. Further, depending on the nature and magnitude of the facts and circumstances leading to an adverse opinion on one or more opinion units, it is possible that the auditor would conclude that it is appropriate to issue an adverse opinion on the financial statements as a whole. (See paragraphs 16.10 and 16.35.) This example assumes that the auditor has concluded that the GAAP departure warrants an adverse opinion on the governmental activities, but not on the financial statements as a whole. Another auditor could make a different professional judgment and issue an adverse opinion on the financial statements as a whole, and thus use the type of report illustrated in example A-8.

[31] See footnote 19.

The amount by which this departure would affect the assets, net position, and expenses of the governmental activities has not been determined.[32]

Adverse Opinion

In our opinion, because of the significance of the matter described in the "Basis for Adverse Opinion on Governmental Activities" paragraph, the financial statements referred to above do not present fairly the financial position of the governmental activities of the City of Example, Any State, as of June 30, 20X1, or the changes in financial position thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Unmodified Opinions

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position and, where applicable, cash flows thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters[33]

[*See illustrative wording in example A-1 and related footnotes for circumstances involving RSI or OI*]

Report on Other Legal and Regulatory Requirements[34]

[*Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities, if any.*]

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

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[32] See footnote 20.

[33] See footnote 4.

[34] See footnote 8.

Example A-7

Report on Basic Financial Statements That Includes an Adverse Opinion on the Governmental Activities Because Compensated Absences Are Omitted[35]

(Paragraphs 16.07–.08 and .34)

Independent Auditor's Report

[*Appropriate Addressee*]

Report on the Financial Statements

[*Same paragraph as in example A-1*]

Management's Responsibility for the Financial Statements

[*Same paragraph as in example A-1*]

Auditor's Responsibility

[*Same paragraphs as in example A-4*]

Summary of Opinions[36]

Opinion Unit	*Type of Opinion*
Governmental Activities	Adverse
Business-Type Activities	Unmodified
Aggregate Discretely Presented Component Units	Unmodified
Governmental Fund X	Unmodified
Governmental Fund Y	Unmodified
Governmental Fund Z	Unmodified
Enterprise Fund A	Unmodified
Enterprise Fund B	Unmodified
Aggregate Remaining Fund Information	Unmodified

Basis for Adverse Opinion on Governmental Activities

As discussed in Note X to the financial statements, management has not recorded a liability for compensated absences in governmental activities and, accordingly, has not recorded an expense for the current period change in that liability. Accounting principles generally accepted in the United States of America require that compensated absences attributable to employee services already rendered and that are not contingent on a specific event that is outside the control of the employer and employee be accrued as liabilities and expenses

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[35] Depending on the nature and magnitude of the GAAP departure, it is possible that the auditor would issue a qualified opinion rather than an adverse opinion. Further, depending on the nature and magnitude of the facts and circumstances leading to an adverse opinion on one or more opinion units, it is possible that the auditor would conclude that it is appropriate to issue an adverse opinion on the financial statements as a whole. (See paragraphs 16.10 and 16.35.) This example assumes that the auditor has concluded that the GAAP departure warrants an adverse opinion on the governmental activities, but not on the financial statements as a whole. Another auditor could make a different professional judgment and either issue a qualified opinion (see example A-10) or issue an adverse opinion on the financial statements as a whole, using the type of report illustrated in example A-8.

[36] See footnote 19.

as employees earn the rights to the benefits, which would increase the liabilities, reduce the net position, and change the expenses of the governmental activities. The amount by which this departure would affect the liabilities, net position, and expenses of the governmental activities has not been determined.[37]

Adverse Opinion

In our opinion, because of the significance of the matter discussed in the "Basis for Adverse Opinion on Governmental Activities" paragraph, the financial statements referred to above do not present fairly the financial position of the governmental activities of the City of Example, Any State, as of June 30, 20X1, or the changes in financial position thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Unmodified Opinions

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position and, where applicable, cash flows thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters[38]

[*See illustrative wording in example A-1 and related footnotes for circumstances involving RSI or OI*]

Report on Other Legal and Regulatory Requirements[39]

[*Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities, if any.*]

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

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[37] See footnote 20.

[38] See footnote 4.

[39] See footnote 8.

Example A-8

Report on Basic Financial Statements That Presents an Adverse Opinion on the Financial Statements as a Whole Because the Government-Wide Financial Statements Are Omitted

(Paragraphs 16.10 and 16.35)

Independent Auditor's Report

[*Appropriate Addressee*]

Report on the Financial Statements

We have audited the accompanying financial statements of each major fund and the aggregate remaining fund information of the City of Example, Any State, as of and for the year ended June 30, 20X1, and the related notes to the financial statements, which collectively comprise a portion of the City's basic financial statements as listed in the table of contents.

Management's Responsibility for the Financial Statements

[*Same paragraph as in example A-1*]

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America.[40] Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our adverse audit opinion.

Basis for Adverse Opinion on the Financial Statements as a Whole

Management has not presented government-wide financial statements to display the financial position and changes in financial position of its governmental activities, business-type activities, and discretely presented component units. Accounting principles generally accepted in the United States of America require the presentation of government-wide financial statements. The amounts that would be reported in government-wide financial statements for the City of Example, Any State's governmental activities, business-type activities, and discretely presented component units have not been determined.[41]

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[40] See footnote 2.

[41] See footnote 20.

Adverse Opinion

In our opinion, because of the significance of the matter discussed in the "Basis for Adverse Opinion" paragraph, the financial statements referred to above do not present fairly the financial position of the City of Example, Any State, as of June 30, 20X1, or the changes in financial position or, where applicable, cash flows thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters[42]

[*See illustrative wording in example A-1 and related footnotes for circumstances involving RSI or OI*]

Report on Other Legal and Regulatory Requirements[43]

[*Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities, if any.*]

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

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[42] See footnote 4.

[43] See footnote 8.

Example A-9

Unmodified Opinions on Basic Financial Statements Accompanied by Required Supplementary Information and Other Information With Reference to an Audit by Another Auditor

(Paragraphs 16.36–.39 and 16.63–.85)

Independent Auditor's Report

[*Appropriate Addressee*]

Report on the Financial Statements

[*Same paragraph as in example A-1*]

Management's Responsibility for the Financial Statements

[*Same paragraph as in example A-1*]

Auditor's Responsibility

Our responsibility is to express opinions on these financial statements based on our audit. We did not audit the financial statements of [*identify organization, function, or activity*], which represent XX percent, XX percent, and XX percent, respectively, of the assets, [*net position, or fund balances*], and revenues of the [*identify opinion unit(s)*].[44] Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for [*identify organization, function, or activity*], is based solely on the report of the other auditors. We conducted our audit in accordance with auditing standards generally accepted in the United States of America.[45] Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

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[44] Appropriate changes to this sentence should be made when an entire opinion unit is audited by another auditor. For example, "We did not audit the financial statements of the Sewer Enterprise Fund, which is both a major fund and XX percent, XX percent, and XX percent, respectively, of the assets, net position, and revenues of the business-type activities." However, the report still should indicate in the "Auditor's Responsibility" section the group auditor's responsibility for auditing that opinion unit. The group auditor should also express or disclaim an opinion in the "Opinion" section of the report. See the further discussion in paragraph 16.85 and the guidance in AU-C section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* (AICPA, *Professional Standards*).

[45] See footnote 2.

Opinions

In our opinion, based on our audit and the report of other auditors, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position and, where applicable, cash flows thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters[46]

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the [*identify required supplementary information, such as management's discussion and analysis and budgetary comparison information*] on pages XX–XX and XX–XX be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We and other auditors[47] have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Information

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the City of Example's basic financial statements. The [*identify accompanying supplementary information, such as the combining and individual nonmajor fund financial statements, and the other information such as the introductory and statistical sections*] are presented for purposes of additional analysis and are not a required part of the basic financial statements.

The [*identify accompanying supplementary information*] is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the basic financial statements or to the basic financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America by us and other auditors. In our opinion, based on our audit, the

[46] See footnote 4.

[47] References to other auditors are only appropriate when the other auditor's report discusses applicable RSI, SI, or both. (see paragraph 16.86).

procedures performed as described above, and the report of the other auditors, the [*identify accompanying supplementary information*] is fairly stated, in all material respects, in relation to the basic financial statements as a whole.

The [*identify the other information*] has not been subjected to the auditing procedures applied in the audit of the basic financial statements, and accordingly, we do not express an opinion or provide any assurance on it.

Report on Other Legal and Regulatory Requirements[48]

[*Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities, if any.*]

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

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[48] See footnote 8.

Example A-10

Report on Basic Financial Statements That Includes Multiple Opinion Modifications, Including an Adverse Opinion Because A Major Fund Is Omitted[49, 50]

(Paragraph 16.53)

<u>Independent Auditor's Report</u>

[*Appropriate Addressee*]

Report on the Financial Statements

We have audited the accompanying financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund (except as described below), and the aggregate remaining fund information of the City of Example, Any State, as of and for the year ended June 30, 20X1, and the related notes to the financial statements, which collectively comprise the City's basic financial statements as listed in the table of contents.

Management's Responsibility for the Financial Statements

[*Same paragraph as in example A-1*]

Auditor's Responsibility

[*Same paragraphs as in example A-4*]

Summary of Opinions[51]

Opinion Unit	*Type of Opinion*
Governmental Activities	Qualified
Business-Type Activities	Qualified
Aggregate Discretely Presented Component Units	Unmodified
Governmental Fund X	Qualified
Governmental Fund Y	Qualified
Governmental Fund Z	Unmodified

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[49] As discussed in paragraph 16.53, the auditor should issue an adverse opinion on a major fund opinion unit when a major governmental or enterprise fund is omitted from the financial statements. (That paragraph also discusses how the auditor should modify the opinion on the remaining fund information opinion unit if the major fund is included in the financial statements but not as a major fund.) However, depending on the nature and magnitude of the other GAAP departures illustrated in this report, it is possible that the auditor might issue an adverse opinion on one or more of the opinion units affected by the omitted or misclassified major fund, or on the financial statements as a whole. This example assumes that the auditor has concluded that qualified opinions on the opinion units affected by the omitted or misclassified major fund are appropriate. Another auditor could make a different professional judgment. (See similar situations handled differently in examples A-5 and A-7.)

[50] This example illustrates providing the various basis for modifications in a separate paragraph followed immediately by a paragraph with the related opinion(s). There is nothing to preclude an auditor from first discussing all modifications in separate paragraphs and then following those paragraphs with the various opinion paragraphs. However, in light of the multiple opinions being provided in this example, the approach provided here may be easier for a user to understand.

[51] See footnote 19.

Opinion Unit	*Type of Opinion*
Enterprise Fund A	Adverse
Enterprise Fund B	Unmodified
Aggregate Remaining Fund Information	Unmodified

Basis for Adverse Opinion on Enterprise Fund A and Qualified Opinion on Business-Type Activities[52]

Management has not included Enterprise Fund A[53] in the City's financial statements. Accounting principles generally accepted in the United States of America require Enterprise Fund A to be presented as a major enterprise fund and financial information about Enterprise Fund A to be part of the business-type activities, thus increasing that activity's assets, deferred outflows of resources, liabilities, deferred inflows of resources, revenues, and expenses, and changing its net position. The amount by which this departure would affect the assets, deferred outflows of resources, liabilities, deferred inflows of resources, net position, revenues, and expenses of the business-type activities and the omitted major fund has not been determined.[54]

Adverse Opinion

In our opinion, because of the significance of the matter discussed in the "Basis for Adverse Opinion on Enterprise Fund A and Qualified Opinion on Business-Type Activities" paragraph, the financial statements referred to above do not present fairly the financial position of Enterprise Fund A of the City of Example, Any State, as of June 30, 20X1, or the changes in financial position or cash flows thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Qualified Opinion

In our opinion, except for the matter described in the "Basis for Adverse Opinion on Enterprise Fund A and Qualified Opinion on Business-Type Activities" paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of the business-type activities of the City of Example, Any State, as of June 30, 20X1, and the changes in financial position thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Basis for Qualified Opinions on Governmental Activities and Governmental Funds X and Y[55]

As discussed in Note X to the financial statements, management has not recorded a liability for compensated absences in governmental activities and, accordingly, has not recorded an expense for the current period change in that liability. Accounting principles generally accepted in the United States of America require that compensated absences attributable to employee services already rendered and that are not contingent on a specific event that is outside

[52] See footnote 25.

[53] This example presumes that the omitted major fund is part of the primary government's legal entity. If, instead, the omitted major fund is a blended component unit and the only component unit, the auditor could instead issue a report on the primary government, as discussed in paragraphs 16.54–.57 and illustrated in examples A-11 and A-12.

[54] See footnote 20.

[55] See footnote 25.

the control of the employer and employee be accrued as liabilities and expenses as employees earn the rights to the benefits, which would increase the liabilities, reduce the net position, and change the expenses of the governmental activities. The amount by which this departure would affect the liabilities, net position, and expenses of the governmental activities has not been determined.[56]

In addition, management has not adopted a methodology for reviewing the collectibility of taxes receivable in the [*identify the affected major governmental funds, such as Major Governmental Funds X and Y*] and in governmental activities and, accordingly, has not considered the need to provide an allowance for uncollectible amounts. Accounting principles generally accepted in the United States of America require that an adequate allowance be provided for uncollectible receivables, which would decrease the assets, fund balances, and net position, and change the revenues in the [*identify the affected funds*] and in governmental activities. The amount by which this departure would affect the assets, fund balances, net position, and revenues of the [*identify the affected funds*] and governmental activities has not been determined.[57]

Qualified Opinions

In our opinion, except for the matters described in the "Basis for Qualified Opinions on Governmental Activities and Governmental Funds X and Y" paragraphs above, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities and the [*identify the affected major governmental funds*] of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Unmodified Opinions

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the aggregate discretely presented component units, [*identify the major funds not affected by the previously described adverse and qualified opinions*], and the aggregate remaining fund information of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position and, where applicable, cash flows thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters[58]

[*See illustrative wording in example A-1 and related footnotes for circumstances involving RSI or OI*]

Report on Other Legal and Regulatory Requirements[59]

[*Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities, if any.*]

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

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[56] See footnote 20.

[57] See footnote 20.

[58] See footnote 4.

[59] See footnote 8.

Example A-11

Unmodified Opinions on the Basic Financial Statements of a Primary Government That Omits the Financial Data of Each Component Unit and That Issues Audited Financial Statements for the Reporting Entity[60,61]

(Paragraphs 16.54–.55)

Independent Auditor's Report

[*Appropriate Addressee*]

Report on the Financial Statements

We have audited the accompanying financial statements of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of and for the year ended June 30, 20X1, and the related notes to the financial statements, which collectively comprise the basic financial statements of the City's primary government as listed in the table of contents.

Management's Responsibility for the Financial Statements

[*Same paragraph as in example A-1*]

Auditor's Responsibility

[*Same paragraphs as in example A-1*]

Opinions

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the primary government of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position and, where applicable, cash flows thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matter[62,63]

As discussed in Note X, the financial statements referred to above include only the primary government of the City of Example, Any State, which consists of all funds, organizations, institutions, agencies, departments, and offices that comprise the City's legal entity. These primary government financial statements do not include financial data for the City's legally separate component units, which accounting principles generally accepted in the United States of America require to be reported with the financial data of the City's primary government. As a result, the primary government financial statements do not purport

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[60] This report should only be used when the entity also has issued audited financial statements for the reporting entity. The report in example A-13 should be used if the entity has not also issued audited financial statements for the reporting entity.

[61] Paragraph 16.44 discusses reporting on financial statements that omit the financial information of one (or more) but not all component units.

[62] When the auditor includes an emphasis-of-matter paragraph in the auditor's report, the auditor should use the heading "Emphasis of Matter" or other appropriate heading.

[63] If the government also has issued audited financial statements for the reporting entity, the auditor's report on separate primary government basic financial statements should contain the required elements listed in paragraph 16.55. Without those elements, such separate basic financial statements for the primary government could be misinterpreted to be the complete basic financial statements of the financial reporting entity. An emphasis-of-matter paragraph should be used to communicate these elements.

to, and do not, present fairly the financial position of the reporting entity of the City of Example, Any State, as of June 30, 20X1, the changes in its financial position, or, where applicable, its cash flows thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

We have audited, in accordance with auditing standards generally accepted in the United States of America, the financial statements of the reporting entity of the City of Example, Any State, as of and for the year ended June 30, 20X1, and our report thereon, dated [*date of report*], expressed an unmodified opinion on those financial statements.

Other Matters[64]

[*See illustrative wording in example A-1 and related footnotes for circumstances involving RSI or OI*]

Report on Other Legal and Regulatory Requirements[65]

[*Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities, if any.*]

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

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64 See footnote 4.

65 See footnote 8.

Example A-12

Report on Basic Financial Statements That Includes Disclaimer of Opinion Because One (But Not All) Discretely Presented Component Unit Is Not Audited[66]

(Paragraphs 16.29–.31)

Independent Auditor's Report

[*Appropriate Addressee*]

Report on the Financial Statements

We have audited the accompanying financial statements of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of and for the year ended June 30, 20X1, and the related notes to the financial statements. We were not engaged to audit the financial statements of the aggregate discretely presented component units. These financial statements collectively comprise City's basic financial statements as listed in the table of contents.

Management's Responsibility for the Financial Statements

[*Same paragraph as in example A-1*]

Auditor's Responsibility

Our responsibility is to express opinions on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement. Because of the matter described in the "Basis for Disclaimer of Opinion" paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the aggregate discretely presented component units.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

Except for the matter described in the Basis for Disclaimer of Opinion paragraph, we believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

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[66] This example assumes that the auditor has concluded that the single unaudited component unit warrants a disclaimer of opinion. Another auditor could make a different professional judgment. An example of a qualified opinion is shown in example A-4 if the auditor was to conclude that a qualified opinion on the aggregate discretely presented component units (but not on the financial statements as a whole) is appropriate.

Summary of Opinions[67]

Opinion Unit	*Type of Opinion*
Governmental Activities	Unmodified
Business-Type Activities	Unmodified
Aggregate Discretely Presented Component Units	Disclaimer
Governmental Fund Y	Unmodified
Governmental Fund Z	Unmodified
Enterprise Fund A	Unmodified
Enterprise Fund B	Unmodified
Aggregate Remaining Fund Information	Unmodified

Basis for Disclaimer of Opinion on the Aggregate Discretely Presented Component Units

The financial statements of Example Component Unit (ECU) have not been audited, and we were not engaged to audit the ECU financial statements as part of our audit of the City's basic financial statements. ECU's financial activities are included in the City's basic financial statements as a discretely presented component unit and represent XX percent, XX percent, and XX percent of the assets, net position, and revenues, respectively, of the City's aggregate discretely presented component units.[68]

Disclaimer of Opinion

Because of the significance of the matter described in the "Basis for Disclaimer of Opinion on the Aggregate Discretely Presented Component Units" paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements of the aggregate discretely presented component units of the City of Example, Any State. Accordingly, we do not express an opinion on these financial statements.

Unmodified Opinions

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position and, where, applicable, cash flows thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters[69]

[*See illustrative wording in example A-1 and related footnotes for circumstances involving RSI or OI*]

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[67] See footnote 19.

[68] See footnote 20.

[69] See footnote 4.

Report on Other Legal and Regulatory Requirements[70]

[*Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities, if any.*]

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

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[70] See footnote 8.

Example A-13

Report on the Basic Financial Statements of a Primary Government That Omits the Financial Data of Each Component Unit and That Does Not Issue Audited Financial Statements for the Reporting Entity[71, 72]

(Paragraphs 16.54 and 16.56)

Independent Auditor's Report

[*Appropriate Addressee*]

Report on the Financial Statements

We have audited the accompanying financial statements of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of and for the year ended June 30, 20X1, and the related notes to the financial statements, which collectively comprise the basic financial statements of the City's primary government as listed in the table of contents.

Management's Responsibility for the Financial Statements

[*Same paragraph as in example A-1*]

Auditor's Responsibility

[*Same paragraphs as in example A-4*]

Summary of Opinions[73]

Opinion Unit	*Type of Opinion*
Governmental Activities	Unmodified
Business-Type Activities	Unmodified
Aggregate Discretely Presented Component Units	Adverse
Governmental Fund Y	Unmodified
Governmental Fund Z	Unmodified

[71] This report should only be used when the entity has not also issued audited financial statements for the reporting entity. The report in example A-11 should be used if the entity has issued audited financial statements for the reporting entity.

[72] This example assumes that the some of the omitted component units would have been discretely presented and that others would have been blended. (See also footnote 75.) It also assumes that the blended component units would have been presented as nonmajor governmental funds and as part of the governmental activities. As discussed in paragraph 16.42, the auditor should issue an adverse opinion on the omitted discretely presented component units opinion unit. (See also footnote 18 in paragraph 16.56.) Depending on the nature and magnitude of the facts and circumstances leading to an adverse opinion on one or more opinion units, it is possible that the auditor would conclude that it is appropriate to issue an adverse opinion on the financial statements as a whole. (See paragraphs 16.10 and 16.35.) This example assumes that the auditor has concluded that the omitted blended component units warrant a qualified opinion on the aggregate remaining fund information opinion unit but are not material to the governmental activities opinion unit. This example also assumes that the auditor has concluded that the omitted component units do not warrant an adverse opinion on the financial statements as a whole. Another auditor could make different professional judgments and express a modified opinion on the governmental activities opinion unit, an adverse opinion on the aggregate remaining fund information opinion unit, or an adverse opinion on the financial statements as a whole (using the type of report illustrated in example A-8).

[73] See footnote 19.

Opinion Unit	*Type of Opinion*
Enterprise Fund A	Unmodified
Enterprise Fund B	Unmodified
Aggregate Remaining Fund Information	Qualified

Basis for Adverse Opinion on the Aggregate Discretely Presented Component Units and Qualified Opinion on the Aggregate Remaining Fund Information[74]

The financial statements do not include financial data for the City's legally separate component units. Accounting principles generally accepted in the United States of America require the financial data for those component units to be reported with the financial data of the City's primary government unless the City also issues financial statements for the financial reporting entity that include the financial data for its component units. The City has not issued such reporting entity financial statements. Because of this departure from accounting principles generally accepted in the United States of America, the assets, deferred outflows of resources, liabilities, deferred inflows of resources, net position, revenues, and expenses of the aggregate discretely presented component units would have been presented as [*indicate the amounts*]. In addition, the assets, deferred outflows of resources, liabilities, deferred inflows of resources, fund balances, revenues, and expenditures of the aggregate remaining fund information would have increased by [*indicate the amounts*].[75,76]

Adverse Opinion

In our opinion, because of the significance of the matter discussed in the "Basis for Adverse Opinion on the Aggregate Discretely Presented Component Units and Qualified Opinion on the Aggregate Remaining Fund Information" paragraph, the financial statements referred to above do not present fairly, the financial position of the aggregate discretely presented component units of the City of Example, Any State, as of June 30, 20X1, or the changes in financial position thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Qualified Opinion

In our opinion, except for the effects of the matter described in the "Basis for Adverse Opinion on the Aggregate Discretely Presented Component Units and Qualified Opinion on the Aggregate Remaining Fund Information" paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of the aggregate remaining fund information of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position and, where applicable, cash flows thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

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[74] See footnote 25.

[75] If none of the omitted component units would have been blended, this paragraph would not refer to the effect on opinion units other than the discretely presented component unit opinion unit, and (absent other reasons to modify the opinions) the report would not contain opinion modifications for other than the discretely presented component unit opinion unit.

[76] See footnote 20.

Unmodified Opinions

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, and each major fund of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position and, where applicable, cash flows thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters[77]

[*See illustrative wording in example A-1 and related footnotes for circumstances involving RSI or OI*]

Report on Other Legal and Regulatory Requirements[78]

[*Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities, if any.*]

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

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[77] See footnote 4.

[78] See footnote 8.

Example A-14

Unmodified Opinions on Basic Financial Statements and on Additional Detail Presented in the Basic Financial Statements[79]

(Paragraph 16.61)

Independent Auditor's Report

[*Appropriate Addressee*]

Report on the Financial Statements

We have audited the accompanying financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of and for the year ended June 30, 20X1, and the related notes to the financial statements, which collectively comprise the City's basic financial statements as listed in the table of contents. We also have audited the aggregate nonmajor governmental funds, the aggregate nonmajor enterprise funds, the internal service fund type, and each fiduciary fund type[80] of the City of Example, Any State, as of and for the year ended June 30, 20X1, as displayed in the City's basic financial statements.

Management's Responsibility for the Financial Statements

[*Same paragraph as in example A-1*]

Auditor's Responsibility

[*Same paragraphs as in example A-1*]

Opinions

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information, as well as the aggregate nonmajor governmental funds, the aggregate nonmajor enterprise funds, the internal service fund type, and each fiduciary fund type of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position and cash flows, where applicable, thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters[81]

[*See illustrative wording in example A-1 and related footnotes for circumstances involving RSI or OI*]

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[79] This report should only be used when the financial statements subject to the more-detailed audit scope are presented in the basic financial statements. The report in example A-15 should be used if the financial statements subject to the more-detailed audit scope are presented as "GASB defined" SI.

[80] The introductory and opinion paragraphs should list only the reporting units that are subject to the more-detailed audit scope.

[81] See footnote 4.

Report on Other Legal and Regulatory Requirements[82]

[*Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities, if any.*]

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

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[82] See footnote 8.

Example A-15

Unmodified Opinions on Basic Financial Statements and on Combining and Individual Fund Financial Statements Presented as "GASB Defined" Supplementary Information[83]

(Paragraphs 16.62 and 16.65)

Independent Auditor's Report

[*Appropriate Addressee*]

Report on the Financial Statements

We have audited the accompanying financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of and for the year ended June 30, 20X1, and the related notes to the financial statements, which collectively comprise the City's basic financial statements as listed in the table of contents. We also have audited the financial statements of each of the City's nonmajor governmental, nonmajor enterprise, internal service, and fiduciary funds presented as supplementary information, as defined by the Government Accounting Standards Board, in the accompanying combining and individual fund financial statements as of and for the year ended June 30, 20X1, as listed in the table of contents.[84]

Management's Responsibility for the Financial Statements

[*Same paragraph as in example A-1*]

Auditor's Responsibility

[*Same paragraphs as in example A-1*]

Opinions

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position and, where applicable, cash flows thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of each nonmajor governmental, nonmajor enterprise, internal service, and fiduciary fund of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position and cash flows, where applicable, thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

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[83] This report should only be used when the financial statements subject to the more detailed audit scope are presented as "GASB defined" SI. The report in example A-14 should be used if the financial statements subject to the more detailed audit scope are presented in the basic financial statements.

[84] The introductory and opinion paragraphs should list only the funds subject to the more-detailed audit scope.

Other Matters[85]

[*See illustrative wording in example A-1 and related footnotes for circumstances involving RSI or OI*]

Report on Other Legal and Regulatory Requirements[86]

[*Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities, if any.*]

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

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[85] See footnote 4.

[86] See footnote 8.

Example A-16

Unmodified Opinion on General Fund Financial Statements

(Paragraphs 16.87–.90)

Independent Auditor's Report

[*Appropriate Addressee*]

Report on the Financial Statements

We have audited the accompanying financial statements of the general fund of the City of Example, Any State, as of and for the year ended June 30, 20X1, and the related notes to the financial statements, as listed in the table of contents.

Management's Responsibility for the Financial Statements

[*Same paragraph as in example A-1*]

Auditor's Responsibility

[*Same paragraphs as in example A-2*]

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the general fund of the City of Example, Any State, as of June 30, 20X1, and the changes in financial position thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.[87,88]

Emphasis of Matter[89,90]

As discussed in Note X, the financial statements present only the general fund and do not purport to, and do not, present fairly the financial position of the City of Example, Any State, as of June 30, 20X1, the changes in its financial position, or, where applicable, its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

Other Matters[91]

[*See illustrative wording in example A-1 and related footnotes for circumstances involving RSI or OI*]

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[87] If the fund being reported on is a proprietary fund, the opinion paragraph also should refer to cash flows.

[88] If the general fund or a major special revenue fund presents budgetary comparison information as a basic financial statement instead of as RSI, the opinion paragraph should be modified to refer to the budgetary comparison in the manner shown in footnote 3. In addition, the emphasis-of-matter paragraph would be replaced with the following: "As discussed in Note X, the financial statements present only the general fund and do not purport to, and do not, present fairly the financial position of the City of Example, Any State, as of June 30, 20X1, and changes in its financial position and budgetary comparisons for the year then ended in accordance with accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter."

[89] As discussed in paragraph 16.88, the auditor's report on an audit of individual fund financial statements should include an emphasis-of-matter paragraph indicating that the financial statements do not purport to, and do not, present the government's financial position, changes in financial position, or, where applicable, cash flows.

[90] See footnote 20.

[91] See footnote 4.

Report on Other Legal and Regulatory Requirements[92]

[*Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities, if any.*]

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

[92] See footnote 8.

Example A-17

Unmodified Opinions on Departmental Financial Statements

(Paragraph 16.91)

Independent Auditor's Report

[*Appropriate Addressee*]

Report on the Financial Statements

We have audited the accompanying financial statements of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the Department of Example, Any State, as of and for the year ended June 30, 20X1, and the related notes to the financial statements, as listed in the tables of contents.

Management's Responsibility for the Financial Statements

[*Same paragraph as in example A-1*]

Auditor's Responsibility

[*Same paragraphs as in example A-1*]

Opinions

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information for the Department of Example, Any State, as of June 30, 20X1, and the respective changes in financial position and, where applicable, cash flows thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.[93]

Emphasis of Matter[94,95]

As discussed in Note X, the financial statements of the Department of Example, Any State, are intended to present the financial position, the changes in financial position and, where applicable, cash flows of only that portion of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the State that is attributable to the transactions of the Department. They do not purport to, and do not, present fairly the financial position of Any State as of June 30, 20X1, the changes in its financial position, or, where applicable, its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

Other Matters[96]

[*See illustrative wording in example A-1 and related footnotes for circumstances involving RSI or OI*]

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[93] If a department presents budgetary comparison information as basic financial statements instead of as RSI. Examples A-1 and A-5 provide modification that would be needed to this report.

[94] As discussed in paragraph 16.91, the auditor's report on departmental, agency, or program financial statements should include an emphasis-of-matter paragraph indicating that the financial statements do not purport to, and do not, present the government's financial position, changes in financial position, or, where applicable, cash flows.

[95] See footnote 20.

[96] See footnote 4.

Report on Other Legal and Regulatory Requirements[97]

[*Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities, if any.*]

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

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[97] See footnote 8.

Example A-18

Report on Separately Issued Summary Financial Information

(Paragraphs 16.93–.102)

Independent Auditor's Report on Summary Financial Statements

[*Appropriate Addressee*]

The accompanying summary financial statements of the City of Example, Any State, as of and for the year ended June 30, 20X1, and the related notes, as listed in the table of contents, are derived from the audited financial statements of governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of and for the year ended June 30, 20X1, and the related notes, which collectively comprise the City's basic financial statements. We expressed an unmodified audit opinion on those audited financial statements in our reported dated [*date of the auditor's report on the financial statements*]. The audited financial statements, and the summary financial statements derived therefrom, do not reflect the effects of events, if any, that occurred subsequent to the date of our report on the audited financial statements.[98]

The summary financial statements do not contain all the disclosures required by accounting principles generally accepted in the United States of America. Reading the summary financial statements, therefore, is not a substitute for reading the audited financial statements of the City of Example, Any State.

Management's Responsibility for the Summary Financial Statements

Management is responsible for the preparation of the summary financial statements on the basis described in Note X.

Auditor's Responsibility

Our responsibility is to express an opinion about whether the summary financial statements are consistent, in all material respects, with the audited financial statements based on our procedures, which were conducted in accordance with auditing standards generally accepted in the United States of America. The procedures consisted principally of comparing the summary financial statements with the related information in the audited financial statements from which the summary financial statements have been derived, and evaluating whether the summary financial statements are prepared in accordance with the basis described in Note X. We did not perform any audit procedures regarding the audited financial statements after the date of our report on those financial statements.

Opinion

In our opinion, the summary financial statements of City of Example, Any State as of and for the year ended June 30, 20X1 referred to above are consistent, in

[98] As indicated in paragraph 16.98, the report should describe any modification of the standard report on the basic financial statements.

all material respects, with the audited financial statements from which they have been derived, on the basis described in Note X.

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

Chapter 17

Financial Statements Prepared in Accordance With a Special-Purpose Framework

Accounting and Financial Reporting Considerations

17.01 Many governments, especially smaller governments, prepare financial statements in accordance with a special-purpose framework other than generally accepted accounting principles (GAAP).[1] Such financial statements are referred to as *special-purpose financial statements*. Paragraph .07 of AU-C section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks* (AICPA, *Professional Standards*), identifies these special-purpose frameworks as the cash basis, tax basis, regulatory basis, contractual basis, or an other basis of accounting. The special-purpose frameworks that could be applicable to financial statements of state and local governments include the following:

- *a.* *The cash basis.* A basis of accounting that the entity uses to record cash receipts and disbursements (commonly referred to as pure cash basis), and modifications of the cash basis having substantial support, such as recording depreciation on capital assets (referred to as modified cash basis).
- *b.* *The regulatory basis.* A basis of accounting that the reporting entity uses to comply with the requirements or financial reporting provisions of a regulatory agency to whose jurisdiction the entity is subject.
- *c.* *The contractual basis.* A basis of accounting that the entity uses to comply with an agreement between the entity and one or more third parties other than the auditor.
- *d.* *An other basis.* A basis of accounting that utilizes a definite set of logical, reasonable criteria that is applied to all material items appearing in financial statements.

17.02 Paragraph .14 of AU-C section 800 states that when forming an opinion and reporting on special-purpose financial statements, the auditor should apply the requirements in AU-C section 700, *Forming an Opinion and Reporting on Financial Statements* (AICPA, *Professional Standards*), and, if applicable, AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report* (AICPA, *Professional Standards*). Paragraph .15 of AU-C section 800 further states that the auditor should evaluate whether the special-purpose financial statements are suitably titled, include a summary of significant accounting policies, and adequately describe how the special-purpose framework differs from GAAP, although the differences from GAAP need not be quantified. In addition, paragraph .17 and appendix B, "Fair Presentation and Adequate Disclosures," of AU-C section 800 state that when special-purpose financial statements contain items that are the same as or similar to those in

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[1] Preparers and auditors could consider reviewing the AICPA's Practice Aid *Applying Special Purpose Frameworks in State and Local Governmental Financial Statements*, which is available for purchase at www.AICPAStore.com. Although nonauthoritative, this publication has been reviewed by subject-matter experts and represents best practice guidance.

financial statements prepared in accordance with GAAP, the auditor should evaluate whether the special-purpose financial statements include informative disclosures similar to those required by GAAP. Also, the auditor should evaluate whether additional disclosures, beyond those specifically required by the special-purpose framework, related to matters that are not specifically identified on the face of the financial statements or other disclosures, are necessary for the special-purpose financial statements to achieve fair presentation. Paragraph .A34 of AU-C section 800 provides that if GAAP set forth requirements that apply to the presentation of financial statements, then special-purpose financial statements may either comply with those requirements or provide information that communicates the substance of those requirements. This paragraph also states that the substance of the applicable GAAP presentation requirements may be communicated using qualitative information and without modifying the special-purpose financial statement format. Generally, that guidance does not permit special-purpose financial statements to omit required basic financial statements or to substitute substantially similar information for a basic financial statement that is required by GAAP.[2] Instead, it permits the substitution of substantially similar information for required display within those financial statements.

17.03 For example, GAAP generally require that basic financial statements present government-wide financial statements, columnar presentations based on major funds, and separate identification of special and extraordinary items. To the extent applicable,[3] special-purpose financial statements should include similar government-wide financial statements and columnar presentations of major funds. (In governmental financial statements, major funds are considered separate *reporting units* equivalent to a required basic financial statement rather than a required display element within the basic financial statements.) However, required line item presentations of special and extraordinary items, for example, could be disclosed in a note to the financial statements rather than on the face of the financial statements. If required basic financial statements applicable to the special-purpose framework are not presented, or material information that would be provided by required display elements is not communicated, the auditor should follow the requirements of AU-C section 705 and modify the opinion(s) on the financial statements. Whether the modifications would be qualified, adverse, or disclaimers of opinions depend on the materiality of the omitted financial statement or information to the affected opinion units.

17.04 Paragraph .08 of AU-C section 800 states that the requirements of the applicable financial reporting framework determine the form and content of the financial statements and what constitutes a complete set of financial

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[2] See, however, paragraph .A34 of AU-C section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks* (AICPA, *Professional Standards*), which explains that special-purpose financial statements may not include a statement of cash flows. If a presentation of cash receipts and disbursements is presented in a format similar to a statement of cash flows or if the entity chooses to present such a statement, the statement would either conform to the requirements for a generally accepted accounting principles presentation or communicate its substance.

[3] As discussed in chapter 12, "Special-Purpose and State Governments," GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, as amended, provides that special-purpose governments engaged only in business-type activities should present the financial statements required for enterprise funds and that special-purpose governments engaged only in fiduciary activities should present the financial statements required for fiduciary funds. Those special-purpose governments are not required to present government-wide financial statements.

statements. The previous paragraph discusses the provisions of AU-C section 800 regarding the presentation requirements for the display of a complete set of special-purpose financial statements. Those provisions do not apply to special-purpose financial statements for which contractual agreements or regulatory requirements direct presentation of less than a complete set of financial statements. Consequently, AU-C section 800 does not require those financial statements to include all of the basic financial statements required by GAAP. For example, a regulatory provision may require the reporting of a schedule of cash receipts and disbursements by fund only. That regulatory basis presentation is not intended to present financial position and is not deficient because it lacks a schedule of cash, nor is the presentation deficient because it lacks other basic financial statements that would be required by GAAP.

17.05 Paragraph .17 of AU-C section 800 states that when special-purpose financial statements contain items that are the same as or similar to those in financial statements prepared in accordance with GAAP, the auditor should evaluate whether the special-purpose financial statements include informative disclosures similar to those required by GAAP. Appendix B of AU-C section 800 provides further guidance to determine the extent of the applicability and relevance of these GAAP similar informative note disclosures. The auditor is also required to evaluate whether additional disclosures, beyond those specifically identified on the face of the financial statement or other disclosures are necessary for the financial statements to achieve fair presentation. The applicable and relevant informative note disclosures that are similar to GAAP may be made by providing information that communicates the substance of those disclosures, possibly by substituting qualitative information for quantitative information. For example, because pure cash basis and modified cash basis financial statements would report pension cost based on amounts actually paid into the plan rather than on an actuarially determined basis, and would therefore present no net pension liability or asset on the face of the financial statements, the GAAP required disclosures related to actuarial calculations for determining the total pension liability would not be relevant to the cash basis or modified cash basis financial statements, and therefore need not be included. However, the GAAP required pension disclosures related to description of the plan, types of benefits provided, funding policy, contribution requirements and rates, and actual cash contributions made, would be applicable to the cash basis or modified cash basis financial statements. As another illustration, the notes to the financial statements may disclose the repayment terms of significant long-term borrowings if that sufficiently communicates information about future principal reduction without providing the summary of principal reduction during each of the next five years and in five-year increments thereafter that would be required for a GAAP presentation.

17.06 Special-purpose financial statements may be accompanied by information that a designated accounting standard setter requires to accompany an entity's basic financial statements in a GAAP presentation (that is, GASB required supplementary information such as management's discussion and analysis and budgetary comparison information). For the purposes of special-purpose financial statements, such information, if included, should be considered (*a*) other information[4] or (*b*) supplementary information if the required

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[4] The auditor's responsibility for this other information is addressed in AU-C section 720, *Other Information in Documents Containing the Audited Financial Statements* (AICPA, *Professional Standards*).

conditions in AU-C section 725, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*), have been met, and the auditor has been engaged to provide an "in relation to" opinion. Auditor reporting on financial statements that contain other information or supplementary information is further discussed in chapters 4, "General Auditing Considerations," and 16, "Audit Reporting," of this guide. In addition, footnote 1 to example A-1 in appendix A, "Illustrative Auditor's Reports," of this chapter illustrates example wording for an other-matter paragraph to report on other information and supplementary information accompanying a set of modified cash basis basic financial statements.

Auditing Considerations

> **Update 17-1 *Going Concern Considerations***
>
> SAS No.132, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, AU-C sec. 570), expands current guidance regarding risk assessment, reporting and auditing considerations related to an entity's ability to continue as a going concern. The standard emphasizes that the responsibility to assess an entity's ability to continue as a going concern lies with management.
>
> The standard provides guidance for periods beyond management's evaluation period and additional audit procedures for when conditions exist that raise substantial doubt about an entity's ability to continue as a going concern.
>
> The standard will supersede the provisions of AU-C section 570A, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*), and amend the provisions of AU-C section 800, *Special Considerations – Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*, and section 930, *Interim Financial Information* (AICPA, *Professional Standards*) upon its effective date.
>
> The standard is effective for audits of financial statements for periods ending on or after December 15, 2017.
>
> Upon its effective date, the standard will affect the guidance related to going concern considerations and special purpose financial statements in this chapter.
>
> The full text of the standard is available on the AICPA's website at www.aicpa.org.

17.07 AU-C section 210, *Terms of Engagement* (AICPA, *Professional Standards*), requires the auditor to determine the acceptability of the financial reporting framework applied in the preparation of the financial statements and establishes certain preconditions for the audit. AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*), states that the purpose of an audit is to provide financial statement users with an opinion by the auditor on whether the financial statements are presented fairly, in all material respects, in accordance with an applicable financial reporting framework. Thus, it would not be appropriate for the financial reporting entity to be presented with multiple financial reporting frameworks (for example, cash basis and GAAP).

17.08 In addition to these requirements, in an audit of special-purpose financial statements, paragraphs .10–.11 of AU-C section 800 further state that the auditor should obtain an understanding of (*a*) the purpose for which the financial statements are prepared, (*b*) the intended users, and (*c*) the steps taken by management to determine that the applicable special-purpose financial reporting framework is acceptable in the circumstances.

17.09 Paragraph .11 of AU-C section 800 describes the precondition that requires the auditor to obtain an agreement with management that it acknowledges and understands its responsibilities to include all informative disclosures appropriate for the special-purpose framework applied, including

- *a.* a description of the special-purpose framework, including a summary of significant accounting policies, and how the special-purpose framework differs from GAAP (quantification of the effects is not required),
- *b.* informative disclosures similar to those required by GAAP, in the case of special-purpose financial statements that contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP,
- *c.* in the case of special-purpose financial statements prepared in accordance with a contractual basis of accounting, a description of any significant interpretations of the contract on which the special-purpose financial statements are based, and
- *d.* any additional disclosures beyond those specifically required by the framework that may be necessary for the special-purpose financial statements to achieve fair presentation.

17.10 AU-C section 200 requires the auditor to comply with all AU-C sections relevant to the audit. In planning and performing an audit of special-purpose financial statements, the auditor should adapt and apply all AU-C sections relevant to the audit as considered necessary in the circumstances. For example, when considering the application of the requirements of AU-C section 320, *Materiality in Planning and Performing an Audit* (AICPA, *Professional Standards*), in an audit of special-purpose financial statements, auditor judgments regarding materiality may need to be adapted to the specific circumstances of the engagement and the needs of the intended users of the special-purpose financial statements, as further discussed in paragraphs 17.12–.13.

17.11 AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), requires the auditor to obtain an understanding of the entity's selection and application of accounting principles. When auditing special-purpose financial statements prepared in accordance with a contractual basis of accounting, the auditor should obtain an understanding of any significant interpretations of the contract (that is, when management's interpretation of a contract provision results in information presented in the financial statements that is materially different information that would have been presented by using another reasonable interpretation) that entity management made in the preparation of the financial statements.

17.12 As discussed in chapters 4, 15, "Concluding the Audit," and 16, auditors should plan, perform, evaluate the results of, and report on audits of a government's GAAP-basis basic financial statements based on opinion units. The auditor also should apply those requirements concerning opinion units to audits of special-purpose financial statements to the extent the opinion unit concept is applicable to the special-purpose framework presentation. For example, special-purpose financial statements (other than those directed by contractual agreements or regulatory requirements as discussed in paragraph 17.14) should conform, in substance, to the presentation requirements of financial statements prepared in accordance with GAAP. Therefore, the opinion unit concept applicable to GAAP financial statements also is applicable to those special-purpose financial statements. Generally, when applying the opinion unit concept to audits of special-purpose financial statements, the auditor should plan, perform, evaluate the results of, and report on the audit based on required presentations that represent (as applicable) the governmental activities; the business-type activities; the aggregate discretely presented component units; each major governmental and enterprise fund; and the aggregate remaining fund information (nonmajor governmental and enterprise funds, the internal service fund type, and the fiduciary fund types).

17.13 For special-purpose financial statements where contractual agreements or regulatory requirements direct the presentation, as discussed in paragraph 17.03 of this guide, the opinion unit concept may not be applicable. For example, the contractual party or regulator may require that the auditor determine materiality and express an opinion on the financial statements a whole. In such cases the auditor should look to guidance from the regulatory agency or contract for determining materiality and the opinion units on which to report. If no guidance is provided, the auditor should use professional judgment in applying the opinion unit concept. In that situation, the auditor may consider disaggregations (such as columnar disaggregations) of the presentation (and perhaps certain aggregations of those presentations that represent *remaining fund information*) to be separate opinion units.

Auditor's Reports

17.14 AU-C section 700 addresses the form and content of the auditor's report on the financial statements. In addition to these reporting requirements, paragraphs .18–.20 of AU-C section 800 state that auditor's reports on special-purpose financial statements should also include

a. within the explanation of management's responsibility, reference to management's responsibility for determining that the applicable financial reporting framework (that is, the special-purpose framework applied) is acceptable in the circumstances, when management has a choice of financial reporting frameworks in the preparation of the financial statements,

b. a description of the purpose for which the financial statements are prepared or reference to a note in the financial statements that contains that information, when the financial statements are prepared in accordance with a regulatory or contractual basis of accounting,

c. except in cases where the financial statements are prepared in accordance with a regulatory basis and are intended for general use (paragraph 17.16 of this guide), an *emphasis-of-matter* paragraph under an appropriate heading that indicates that the financial statements are prepared in accordance with the applicable special-purpose framework, refers to the note to the financial statements that describe that framework, and states that the special-purpose framework is a basis of accounting other than GAAP, and *d.* in cases when the financial statements are prepared in accordance with a regulatory or contractual basis of accounting and the financial statements and auditor's report are intended solely for those within the entity, the regulatory agencies to whose jurisdiction the entity is subject, or the parties to the contract or agreement, an *other-matter* paragraph under an appropriate heading that restricts the use of the auditor's report to those specified intended users in accordance with paragraph .20 of AU-C section 800 (see paragraph 17.16 for regulatory basis financial statements intended for general use).[5]

An example of an unmodified opinion on modified cash basis financial statements is shown in example A-1 in appendix A of this chapter.

17.15 In the case of special-purpose financial statements prepared in accordance with the cash or modified cash basis of accounting, a restricted use other-matter paragraph is not required. However, the auditor may consider it necessary in the circumstances to restrict the use of the auditor's report and is not precluded from including an other-matter paragraph restricting its use.

17.16 Paragraph .21 of AU-C section 800 states that if regulatory basis financial statements and accompanying auditor's report are intended for general use, the auditor should not include the emphasis-of-matter or other-matter paragraphs discussed in paragraph 17.14*c–d*. Instead, the auditor should express an opinion about whether the special-purpose financial statements are presented fairly, in all material respects, in accordance with GAAP. The auditor should also, in a separate paragraph, express an opinion regarding whether the financial statements are prepared in accordance with the applicable regulatory basis framework. The regulatory basis financial statements and auditor's report are considered intended for general use when they are intended for use by parties other than those within the entity and the regulatory agencies to whose jurisdiction the entity is subject or when the financial statements and auditor's report are distributed by the entity to parties other than the regulatory agencies, either voluntarily or upon specific request. An example of such a report is shown in example A-2 in appendix A of this chapter. Appendix B, "Overview of Reporting Requirements for Special-Purpose Financial Statements," of this chapter provides an overview of auditor reporting requirements applicable to financial statements prepared in accordance with special-purpose frameworks, including the differences in reporting on regulatory basis financial statements that are restricted as to use and those intended for general use.

[5] Such a paragraph is appropriate even though by law or regulation the auditor's report may be a matter of public record.

17.17

Appendix A—Illustrative Auditor's Reports

This appendix illustrates auditor's reports in specific situations discussed in this chapter. Auditors should modify the illustrative report as needed in different situations. Appendix A, "Illustrative Auditor's Reports," to chapter 16 describes conditions that may make modifications necessary. The illustrative reports in this appendix follow.

Example A-1—Unmodified Opinions on Basis Financial Statements Prepared in Accordance With the Modified Cash Basis of Accounting

Example A-2—Financial Statements Prepared in Accordance With a Regulatory Basis of Accounting (the Financial Statements Together With the Auditor's Report Are Intended for General Use)

Example A-1

Unmodified Opinions on Basic Financial Statements Prepared in Accordance With the Modified Cash Basis of Accounting[1]

<u>Independent Auditor's Report</u>

[*Appropriate Addressee*]

Report on the Financial Statements

We have audited the accompanying modified cash-basis financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and aggregate remaining fund information of the City of Example, Any State, as of and for the year ended June 30, 20XX, and the related notes to the financial statements, which collectively comprise the City's basic financial statements as listed in the table of contents.

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[1] The following paragraphs illustrate reporting in situations in which the auditor has been engaged to provide an "in-relation-to" opinion on supplementary information (SI), the auditor is issuing an unmodified opinion on the financial statements, and the auditor has concluded that the SI is fairly stated, in all material respects, in relation to the financial statements as a whole. If there is no SI on which to report, the references to SI in these paragraphs would be deleted. If the auditor has issued an opinion other than unmodified on the financial statements, see the guidance in AU-C section 725, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*). Additionally, the other information (OI) reporting illustrated in this example provides an example of explanatory language that the auditor may use to disclaim an opinion on OI. Note there is no required reporting on OI under AU-C section 720, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*). If there is no OI contained in the document containing the audited financial statements or if the auditor chooses not to include the disclaimer, the references to OI in this section would be deleted. See AU-C section 720 for more information.

The captions provided in this illustration are one way an auditor could title the section. Alternatively, the auditor could title it "Supplementary and Other Information," "Supplementary Information," or "Accompanying Information." See AU-C section 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report* (AICPA, *Professional Standards*), for more information.

> ***Other Matters***
>
> *Other Information*
>
> Our audit was conducted for the purpose of forming opinions on the financial statements as a whole that collectively comprise the City of Example's basic financial statements. The [*identify accompanying supplementary information, such as budgetary comparison information and combining and individual nonmajor fund financial statements, and other information, such as management's discussion and analysis, introductory information and statistical or trend schedules*] are presented for purposes of additional analysis and are not a required part of the basic financial statements.
>
> The [*identify accompanying supplementary information*] presented on pages [*insert applicable page numbers*] is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the basic financial statements or to the basic financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the [*identify supplementary information*] is fairly stated, in all material respects, in relation to the basic financial statements as a whole on the basis of accounting described in Note X.
>
> The [*identify other information, such as management's discussion and analysis, introductory information, and statistical and trend schedules*] has not been subjected to the auditing procedures applied in the audit of the basic financial statements, and accordingly, we do not express an opinion or provide any assurance on it.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with the modified cash basis of accounting described in Note X; this includes determining that the modified cash basis of accounting is an acceptable basis for the preparation of the financial statements in the circumstances. Management is also responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express opinions on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

Opinions

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective modified cash-basis financial position of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of June 30, 20XX, the respective changes in modified cash-basis financial position; and, where applicable, cash flows[2] thereof for the year then ended in accordance with the modified cash basis of accounting described in Note X.

Basis of Accounting

We draw attention to Note X of the financial statements, which describes the basis of accounting. The financial statements are prepared on the modified cash basis of accounting, which is a basis of accounting other than accounting principles generally accepted in the United States of America. Our opinions are not modified with respect to this matter.

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[2] Reference to cash flows would not be needed if the entity, under generally accepted accounting principles, is not required to present a statement of cash flows.

Report on Other Legal and Regulatory Requirements[3]

[*Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities, if any.*]

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of auditor's report*]

[3] In some circumstances, the auditor may have additional responsibilities to report on other matters that are supplementary to the auditor's responsibility under generally accepted auditing standards. When there are such other reporting responsibilities, they should be addressed in a separate section in the auditor's report. The form and content of the "Other Reporting Responsibilities" section of the auditor's report are described in paragraph .37 of AU-C section 700, *Forming an Opinion and Reporting on Financial Statements* (AICPA, *Professional Standards*). One common example of such additional reporting responsibilities is when the audit is conducted in accordance with *Government Auditing Standards*. See the AICPA Audit Guide Government Auditing Standards *and Single Audits* for further discussion of this and other modifications that would be made when the audit is performed under *Government Auditing Standards*.

Example A-2

Financial Statements Prepared in Accordance With a Regulatory Basis of Accounting (the Financial Statements Together With the Auditor's Report Are Intended for General Use)[4]

Independent Auditor's Report

[*Appropriate Addressee*]

Report on the Financial Statements

We have audited the accompanying financial statements of the City of Example, Any State, which comprise cash and unencumbered cash for each fund as of June 30, 20XX, and the related statements of cash receipts and disbursements and disbursements—budget and actual[5] for the year then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with the financial reporting provisions of [*identify applicable regulatory provisions*], as described in Note X. Management is also responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

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[4] This example report assumes the financial statements consist of a columnar presentation of each fund of the entity presenting the beginning and ending cash and unencumbered cash, cash receipts and disbursements, and a schedule of disbursements-budget and actual for each fund. This example report should be modified for different circumstances.

[5] This example report assumes that each presented fund is a separate opinion unit. If, instead, regulatory requirements or other circumstances require the auditor to express an opinion on the financial statements as a whole (see paragraph 17.13), the scope and opinion wording would not refer to each fund or to opinions, but would rather refer to the financial statements of the entity and to an opinion.

Basis for Adverse Opinion on U.S. Generally Accepted Accounting Principles

As described in Note X of the financial statements, the financial statements are prepared by City of Example on the basis of the financial reporting provisions of [*reference to applicable regulatory provisions*], which is a basis of accounting other than accounting principles generally accepted in the United States of America, to meet the requirements of [*identify to the applicable regulatory entity*].

The effects on the financial statements of the variances between the regulatory basis of accounting described in Note X and accounting principles generally accepted in the United States of America, although not reasonably determinable, are presumed to be material.

Adverse Opinion on U.S. Generally Accepted Accounting Principles

In our opinion, because of the significance of the matter discussed in the "Basis for Adverse Opinion on U.S. Generally Accepted Accounting Principles" paragraph, the financial statements referred to above do not present fairly, in accordance with accounting principles generally accepted in the United States of America, the financial position of each fund of the City of Example as of June 30, 20XX, or changes in net position or cash flows thereof for the year then ended.

Unmodified Opinions on Regulatory Basis of Accounting

In our opinion, the financial statements referred to above present fairly, in all material respects, the cash and unencumbered cash of each fund of the City of Example as of June 30, 20XX, and their respective cash receipts and disbursements, and budgetary results for the year then ended in accordance with the financial reporting provisions of [*identify applicable regulatory provisions*] described in Note X.

Report on Other Legal and Regulatory Requirements[6]

[*Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities, if any.*]

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

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[6] See footnote 3.

17.18

Appendix B—Overview of Reporting Requirements for Special-Purpose Financial Statements

This appendix provides an overview of auditor reporting requirements that are applicable to special-purpose frameworks that could be applied by state and local governments.

	Cash Basis or Modified Cash Basis	***Regulatory Basis Restricted Use***	***Regulatory Basis (General Use)***	***Contractual Basis***	***Other Basis***
Opinion(s)	Opinion(s) on special-purpose framework	Opinion(s) on special-purpose framework	Dual opinion on special-purpose framework and generally accepted accounting principles	Opinion(s) on special-purpose framework	Opinion(s) on special-purpose framework
Description of purpose for which special-purpose financial statements are prepared	No	Yes	Yes	Yes	As required by paragraph .18*b*(ii) of AU-C section 800
Emphasis-of-matter paragraph alerting readers to preparation in accordance with a special-purpose framework	Yes	Yes	No	Yes	Yes
Other-matter paragraph restricting the use of the auditor's report	No	Yes	No	Yes	As required by AU-C section 905

Chapter 18

Auditor Involvement With Municipal Securities Filings

Introduction

18.01 Governments generally issue debt securities—known as *municipal securities*—through negotiated sales, competitive bids, or private placements. In a negotiated sale, the government negotiates a price with one or more underwriters. In a competitive bid sale, the government sells the securities to one or more underwriters who submitted the best acceptable bid. The underwriters then resell the securities to the public. In a private placement, which frequently occurs for small issues, the government sells the securities directly to the investor, usually a local bank.

18.02 A government that is selling securities prepares an official statement[1] that offers the securities for sale and provides appropriate financial and other information about the offering and the government. Financial advisers and bond counsel and, frequently, engineers, appraisers, and independent auditors, assist the government in preparing information for the official statement. The following are important stages in a municipal securities offering; the time periods between these stages may vary:

- The preliminary official statement is issued to all prospective buyers of the securities.
- The official statement is issued at the time of sale (sometimes referred to as the effective date) and identifies the buyers and the actual debt service requirements of the securities.
- The closing date is the date the transaction is finalized and the cash is transferred from the buyers to the government.

18.03 Municipal securities are exempt from all of the provisions of the Securities Act of 1933 (1933 Act) and the Securities Exchange Act of 1934 except the antifraud provisions of Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 (and the associated Rule 10b-5). Those antifraud provisions prohibit any person from misrepresenting or omitting material facts in the offering or sale of securities.

18.04 SEC Rule 15c2-12 (Title 17 U.S. *Code of Federal Regulations* Part 240.15c2-12), as amended, and associated SEC releases impose certain requirements on the underwriters of municipal securities. Because of Rule 15c2-12, as amended, issuers of most municipal securities offerings over set dollar amounts and primary issuers of variable rate demand obligation (or VRDO) offerings provide certain disclosures when issuing securities (primary market disclosures) as well as at certain times thereafter (continuing disclosures).[2] Primary market disclosures are made by issuing an official statement. Continuing disclosures are made by providing to the Municipal Securities Rulemaking Board

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[1] *Official statement* is the common term used for the offering document or offering circular for municipal securities.

[2] Some literature also refers to continuing disclosures using the term *secondary market disclosures*.

(MSRB) (*a*) annual continuing disclosures as contractually established and (*b*) events notices. Annual continuing disclosures are financial information, including audited financial statements, which are updated annually. Events notices, which are required for specific events with respect to municipal securities, such as principal and interest payment delinquencies and nonpayment related defaults, are provided on an as-needed basis and do not involve financial statements. Issuers under continuing disclosure agreements entered into in connection with primary offerings of municipal securities subject to Rule 15c2-12 that occurred on or before November 30, 2010, are required to notify the MSRB of any of 11 specific events, if determined material, in a timely manner. Issuers under continuing disclosure agreements entered into in connection with primary offerings of municipal securities subject to Rule 15c2-12 that occurred on or after December 1, 2010, are required to notify the MSRB of any of 15 events "in a timely manner not in excess of ten business days after the occurrence of the event." For these issuers, certain events are required to be reported without regard to materiality, whereas certain other events are reported based on materiality.

18.05 Rule 15c2-12, as amended, requires the underwriter of a municipal securities offering to reasonably determine that the issuer or obligated person has undertaken in its continuing disclosure agreement to provide continuing disclosure documents (*a*) solely to the MSRB and (*b*) in an electronic format and accompanied by identifying information as prescribed by the MSRB. An issuer or obligated person provides continuing disclosure information using the MSRB's Electronic Municipal Market Access (EMMA) system.[3] However, such filings with the MSRB (using the EMMA system) do not affect the legal obligations or contractual disclosure agreements of issuers and obligated persons to provide continuing disclosure documents, along with any other submissions, to the appropriate state information depositories, as required under the appropriate state law. This does not affect the obligation of issuers and obligated persons under outstanding continuing disclosure agreements entered into prior to July 1, 2009, to submit continuing disclosure documents to the appropriate State Information Depository, if any, as stated in their continuing disclosure agreements, nor on their obligation to make any other submissions that may be required under appropriate state law.

18.06 In its Release No. 33-7049 and 34-33741,[4] *Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others*, the SEC encourages market participants to continue to refer to voluntary guidelines (such as the guidelines prepared by the Government Finance Officers Association) and the SEC's Interpretive Release in preparing official statements and continuing disclosure documents.

Auditor Involvement

Conditions Affecting Auditor Involvement

18.07 Because there is no SEC requirement for auditor involvement with governmental official statements, an auditor generally is not required to

[3] Electronic Municipal Market Access (EMMA) receives electronic submissions of, and makes publicly available, continuing disclosure documents and related information on the EMMA website at http://emma.msrb.org.

[4] Note that the SEC release is one release that has two numbers: one for the Securities Exchange Act of 1933 and one for the Securities Exchange Act of 1934.

participate in, or undertake any procedures with respect to, a government's official statement.[5] The following are activities the auditor may become involved in with respect to the official statement:

- Assisting in preparing the financial information[6] included in the official statement
- Reviewing a draft of the official statement at the government's request
- Signing (either manually or electronically) the independent auditor's report for inclusion in a specific official statement[7]
- Providing written agreement (for example, through a consent letter or signed authorization form) for the use of the independent auditor's report in a specific official statement (See paragraphs 18.17–.20.)
- Providing a revised independent auditor's report[8] for inclusion in a specific official statement
- Issuing a comfort letter, the letter described in paragraph .12 of AU-C section 920, *Letters for Underwriters and Certain Other Requesting Parties* (AICPA, *Professional Standards*), or an attestation engagement report in lieu of a comfort or similar letter on information included in the official statement (See paragraphs 18.12–.16.)
- Issuing a practitioner's report on an attestation engagement relating to the debt offering (See paragraph 18.23.)

18.08 Although AU-C section 720, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*), addresses auditor responsibilities with respect to other information contained in documents such as annual reports, paragraph .02 of AU-C section 720 states that it may be applied, adapted as necessary in the circumstances, to other documents to which the auditor devotes attention. Therefore, if the auditor is involved with an official statement, the guidance in AU-C section 720 may be applied. Chapters 4, "General Auditing Considerations" and 16, "Audit Reporting," further discuss the requirements and guidance contained within AU-C section 720. If the guidance in AU-C section 720 is applied, the auditor should communicate the auditor's responsibility for other information in a document containing audited financial statements, any procedures performed, and the results.

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[5] Some auditors require that they become involved with a government's official statements even though the conditions described in this paragraph establishing involvement would not otherwise exist. See the discussion at paragraph 18.10.

[6] For the purpose of this requirement, *financial information* does not include the financial statements covered by the auditor's opinion or the required supplementary information (RSI) or supplementary information other than RSI accompanying those financial statements that the auditor already considered during his or her audit of the financial statements.

[7] This situation involves an original manual or electronic signature on the auditor's report, not a reproduction of an auditor's report that was manually or electronically signed. For example, the underwriter or bond counsel may require a copy of the auditor's report with an original manual or electronic signature to file with the official closing documents for the offering.

[8] A revised report would, for example, eliminate the references made by the auditor in the original report to (*a*) supplementary information that the auditor reported on in relation to the basic financial statements or (*b*) the audit and reports required by *Government Auditing Standards* (also referred to as the Yellow Book), issued by the Comptroller General of the United States.

18.09 The auditor is not required to participate in, or undertake any procedures with respect to, a government's continuing disclosure documents, even though they may include audited financial statements because a government's continuing disclosures are not required to be submitted to or disseminated from the distributing organizations as a single document. Any attention the auditor devotes to other information included with audited financial statements in continuing disclosure documents at the government's request may be considered, as appropriate, a consulting engagement under the provisions of CS section 100, *Consulting Services: Definitions and Standards* (AICPA, *Professional Standards*), or an attestation engagement under the provisions of AT-C section 205, *Examination Engagements* (AICPA, *Professional Standards*), AT-C section 210, *Review Engagements* (AICPA, *Professional Standards*), or AT-C section 215, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*).

Auditor-Established Involvement

18.10 Although an auditor is not required to become involved with a government's official statements, some auditors include a provision in the terms of the engagement requiring the government to obtain permission from the auditor before using the independent auditor's report in the official statement. Such a provision may be used by the auditor to establish a requirement that the auditor become involved with the government's official statements when the government requests the required permission from the auditor.

Clarification in the Official Statement When There Is No Auditor Involvement

18.11 When the auditor and client agree not to include a provision in the terms of the engagement that would require auditor involvement (see paragraph 18.10), the auditor may include in the terms of the engagement a requirement that any official statements issued by the government with which the auditor is not involved clearly indicate the auditor is not involved with the contents of such official statements. Such a disclosure could read as "[*Name of firm*], our independent auditor, has not been engaged to perform and has not performed, since the date of its report included herein, any procedures on the financial statements addressed in that report. [*Name of firm*] also has not performed any procedures relating to this official statement."

Using *Government Auditing Standards* Reports and References in the Official Statement

18.12 If the auditor is involved with a government's official statements, the auditor should consider which auditor's reports the government presents in the official statement. It is generally advisable for the official statements to use an auditor's report on the financial statements that does not refer to the *Government Auditing Standards* audit or to those separate reports because those references, without the presentation of the reports in the official statements, could confuse the users of the official statement.

Letters for Underwriters

18.13 Underwriting agreements between a government and its underwriters may require the auditor to prepare a comfort letter addressed to the underwriters. AU-C section 920 defines the term *underwriters* and gives guidance to auditors[9] when engaged to issue letters to underwriters and to certain other requesting parties in connection with a nonissuer entity's financial statements included in registration statements filed with the SEC under the 1933 Act. An auditor may provide a comfort letter to a broker-dealer or other financial intermediary acting as principal or agent in offerings of securities issued or backed by governmental entities exempt from registration under the 1933 Act only if the broker-dealer or other financial intermediary provides the required representation letter described in paragraph .11 of AU-C section 920. The required elements of the representation letter from the broker-dealer or other financial intermediary are as follows:

- The letter should be addressed to the auditor.
- The letter should contain the following:

  > The review process applied to the information relating to the issuer, is or will be, substantially consistent with the due diligence process that we would perform if this securities offering were being registered pursuant to the Securities Act of 1933. We are knowledgeable with respect to that due diligence process.

- The letter should be signed by the requesting broker-dealer or other financial intermediary.

18.14 When a party requesting a comfort letter has provided the auditor with the required representation letter, the auditor should refer to the requesting party's representations in the comfort letter. See example A-2 in paragraph .A93 of AU-C section 920, which is a typical comfort letter in a non-1933 Act offering, including the required underwriter representations. If the required representation letter is not provided by the broker-dealer or other financial intermediary, paragraph .12 of AU-C section 920 provides requirements and guidance for auditors. See example Q in .A93-19 of AU-C section 920 for the relevant illustration. As discussed in paragraph .13 of AU-C section 920, when a comfort letter is requested by a party other than the underwriter, broker-dealer, or other financial intermediary, the auditor should not provide that party with a comfort letter or the letter described in paragraph .12 of AU-C section 920. Instead, the auditor may provide the party with a practitioner's report on agreed-upon procedures and should refer to AT-C section 215 for additional specific guidance. (See paragraph .A7 of AU-C section 920).

18.15 Paragraph .45 of AU-C section 920 requires the auditor to perform a review, as discussed in AU-C section 930, *Interim Financial Information* (AICPA, *Professional Standards*), to provide negative assurance in a comfort letter on interim financial information. A review of interim financial information may be conducted under AU-C section 930 if

- the entity's latest annual financial statements have been audited by the auditor or a predecessor auditor;
- the auditor has been engaged to audit the entity's current year financial statements, or the auditor audited the entity's latest annual financial statements and in situations in which the engagement of another auditor to audit the current year financial

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[9] Because of its use in SEC literature, certain auditing literature uses the term *accountant* to refer to the auditor. However, this chapter replaces the term *accountant* with the term *auditor*.

statements is not effective prior to the beginning of the period covered by the review;

- the interim information is prepared in accordance with the same financial reporting framework as that used to prepare the annual financial statements; and
- any condensed financial statement (*a*) purports to be prepared in accordance with an appropriate financial reporting framework which includes appropriate form and content of the interim financial statements; (*b*) includes a note that the financial information does not represent complete financial statements and is to be read in conjunction with the latest annual audited financial statements; and (*c*) the condensed interim financial information accompanies the entity's latest audited annual financial statements or such audited annual statements are made readily available[10] by the entity.

If AU-C section 930 is not applicable (for example, the condensed financial statement is presented on a budgetary basis of accounting), the review engagement may be performed under Statements on Standards for Attestation Engagements or Statements on Standards for Accounting and Review Services.

18.16 If the auditor has not performed such a review, paragraphs .45 and .60 of AU-C section 920 prohibit the auditor from giving negative assurance with respect to whether any material modifications should be made to the interim financial information for it to be in accordance with generally accepted accounting principles and from providing negative assurance as to subsequent changes in financial statements items from the date of the interim financial information. Instead, the auditor is limited to reporting procedures performed and findings obtained. The letter should specifically state that the auditor has not audited the interim financial information in accordance with generally accepted auditing standards and does not express an opinion concerning such information. An example of that language is in the third statement of the example A-1 comfort letter in AU-C section 920.

18.17 When the auditor is asked to prepare a letter for the underwriter, the letter can be as of the preliminary official statement date or the official statement date (as defined in paragraph 18.02), with updating letters issued as of the official statement date (if applicable) and the closing date. Paragraphs .A24–.A25 of AU-C section 920 state that the letter ordinarily is dated on, or shortly after, the underwriting agreement is signed, and the underwriting agreement ordinarily specifies the date, often referred to as the cutoff date, to which certain procedures described in the letter are to relate (for example, a date five days before the date of the letter). A factor in considering whether to accept the engagement is whether the period between the cut-off date and the date of the letter provides sufficient time to allow the auditor to perform the procedures and prepare the letter. The five-day cut-off period in AU-C section 920 is illustrative only and does not set a standard, but practice generally does not exceed a five-day cut-off period.

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[10] According to paragraph .A3 of AU-C section 930, *Interim Financial Information* (AICPA, *Professional Standards*), audited financial statements are deemed readily available if a third party user can obtain the statements without any further action by the entity (financial statements on an entity's website would be considered readily available whereas statements that are available on request would not).

Auditing Interpretations Regarding Governmental Official Statements

18.18 Exhibit A, "Background," of AU-C section 925, *Filings With the U.S. Securities and Exchange Commission Under the Securities Act of 1933* (AICPA, *Professional Standards*), addresses the auditor's agreement[11] to (*a*) being named in and (*b*) the use of an auditor's report in an offering document other than one registered under the of 1933 Act.[12]

18.19 Paragraph 16 of exhibit A of AU-C section 925 states that when a client wishes to make reference to the auditor's role in an offering document in connection with a securities offering that is not registered under the 1933 Act, the caption "Independent Auditors" (or something similar) would generally be used to title that section of the document rather than "Experts," with no reference to the auditor as an "expert" anywhere in the document. Exhibit B, "Illustrative Disclosures and Reports," of AU-C section 925 provides the following example of a typical description of the auditor's role.[13]

Independent Auditors

> The financial statements of [*name of entity*] as of December 31, 20XX, and for the year then ended, included in this offering circular, have been audited by ABC & Co., independent auditors, as stated in their report(s) appearing herein.

If the client refuses to delete from the offering document the reference to the auditor as an "expert," the auditor should not permit inclusion of the auditor's report in the offering document.

18.20 Paragraphs 19–20 of exhibit A of AU-C section 925 state that when an auditor's report is used in connection with an offering transaction that is not registered under the 1933 Act, it is usually not necessary for the auditor to provide any type of written consent. If the auditor is asked to provide a written consent for use in connection with a document other than a 1933 Act registration statement, then the auditor may provide a letter indicating that the auditor agrees to the inclusion of the auditor's report on the audited financial statements in the offering materials. This letter would not typically be included in the offering materials. The following example language may be used:

> We agree to the inclusion in the offering circular of our report, dated February 5, 20XX, on our audit of the financial statements of [*name of entity*].

18.21 As stated in paragraph .08 of AU-C section 925, the auditor should determine that the auditor's name is not being used in a way that indicates that the auditor's responsibility is greater than the auditor intends. Therefore, if the client refuses to delete from the offering document the reference to the auditor as an expert, then the auditor should not permit inclusion of the auditor's report in the offering document.

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[11] The term *consent* is an SEC term that relates to registered securities, and municipal securities are not registered securities. Therefore, this guide uses the term *agreement*, even though the AICPA interpretations discussed refer to *consent*.

[12] As discussed in footnote 1, governments generally refer to the offering document or offering circular for municipal securities as an official statement.

[13] As discussed in paragraph 18.11, if the auditor is not involved with the offering document and the terms of the engagement require disclosure of this fact, additional disclosure similar to that illustrated in paragraph 18.11 should be included here.

18.22 When the auditor is asked to issue a letter agreeing to the use of the auditor's report in the offering document, the effective date of the letter can be the preliminary official statement date or the official statement date (as defined in paragraph 18.02).

Attestation Engagements Related to Municipal Securities Issuances

18.23 During the process of issuing municipal securities, governments or other involved parties often engage practitioners to provide certain needed information. These engagements should be conducted in accordance with the appropriate professional attestation standards as agreed to by the engaging government and the practitioner.[14] For example, a government or its bond counsel may engage a practitioner to review the government's compliance with the revenue coverage requirements on outstanding bonds or to verify the calculation of escrow account requirements for an advance refunding of bonds. If the auditor of the financial statements included in the official statement also provides a practitioner's report on an attestation engagement relating to a debt offering, that establishes an involvement with the official statement, as indicated in paragraph 18.07. A practitioner's report on an attestation engagement relating to a debt offering need not be referred to or included in the official statement to involve the auditor of the financial statements with the official statement. Sometimes, the practitioner's report on an attestation engagement may only be included in the official closing documents for the offering. Also, if the practitioner providing the report on an attestation engagement is not the auditor of the financial statements included in the official statements, the issuance of the practitioner's report on an attestation engagement does not, by itself, involve either the auditor of the financial statements or the practitioner who issued the report on the attestation engagement with the official statement.

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[14] Generally, these attestation engagements are performed only in accordance with the AICPA's Statements on Standards for Attestation Engagements. However, if the auditor is performing the engagement in accordance with *Government Auditing Standards*, the auditor should apply the guidance of *Government Auditing Standards*, including chapter 5, "Standards for Attestation Engagements." Interpretation No. 1, "Reporting on Attestation Engagements Performed in Accordance With *Government Auditing Standards*" (AICPA, *Professional Standards*, AT-C sec. 9205 par. .01–.03), of AT-C section 205, *Examination Engagements*, explains how an examination report should be modified when the engagement is performed in accordance with *Government Auditing Standards* and provides an illustrative attestation report. A practitioner may use this guidance to help the practitioner appropriately modify an attestation report pursuant to other AT-C sections.

Supplement

Statement of Position 98-2

This supplement contains authoritative GASB material.

Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising

Statement of Position (SOP) 98-2 includes governmental entities in its scope and its accounting and financial reporting requirements were cleared by GASB and, thus, those portions are category B accounting and financial reporting guidance for state and local governmental entities. Portions that are category B accounting and financial reporting guidance for state and local governmental entities appear in orange font.

March 11, 1998

NOTE

Statements of Position (SOPs) on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. GASB Statement No. 76, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*, identifies AICPA literature that has specifically been made applicable to state and local governmental entities and cleared by GASB as a source of authoritative accounting principles in category B of the generally accepted accounting principles (GAAP) hierarchy for state and local governmental entities. AICPA members should consider the accounting principles in this SOP if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by the "Accounting Principles Rule" (ET sec. 1.320.001) of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this SOP should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

Summary

This Statement of Position (SOP) applies to all nongovernmental not-for-profit organizations (NPOs) and all state and local governmental entities that solicit contributions.

This SOP requires—

- If the criteria of purpose, audience, and content as defined in this SOP are met, the costs of joint activities that are identifiable with a particular function should be charged to that function and joint costs should be allocated between fund raising and the appropriate program or management and general function.
- If any of the criteria of purpose, audience, and content are not met, all costs of the activity should be reported as fund-raising costs, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity, subject to the exception in the following sentence. Costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should not be reported as fund raising.
- Certain financial statement disclosures if joint costs are allocated.
- Some commonly used and acceptable allocation methods are described and illustrated although no methods are prescribed or prohibited.

This SOP amends existing guidance in AICPA Audit and Accounting Guides *Health Care Organizations*, *Not-for-Profit Organizations* (which was issued in August 1996 and supersedes SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, because the provisions of SOP 87-2 are incorporated into the Guide), and *Audits of State and Local Governmental Units*.*

This SOP is effective for financial statements for years beginning on or after December 15, 1998. Earlier application is encouraged in fiscal years for which financial statements have not been issued. If comparative financial statements are presented, retroactive application is permitted but not required.

Foreword

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB) and the Governmental Accounting Standards Board (GASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB and the GASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (3) a proposed final document that has been approved by at least

* The AICPA Audit and Accounting Guide *State and Local Governments* supersedes the 1994 AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* and subsequent editions of that Guide with conforming changes made by the AICPA staff. The AICPA Audit and Accounting Guide *State and Local Governments* provides guidance on the application of this Statement of Position (SOP) to state and local governments. [Footnote added, June 2004, to reflect conforming changes necessary due to the issuance of the AICPA Audit and Accounting Guide *State and Local Governments*.]

ten of AcSEC's fifteen members. The document is cleared if at least five of the seven FASB members and three of the five GASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.[†]

The criteria applied by the FASB and the GASB in their review of proposed projects and proposed documents include the following:

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
2. The proposal will result in an improvement in practice.
3. The AICPA demonstrates the need for the proposal.
4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB and the GASB will propose suggestions, many of which are included in the documents.

[†] This document was cleared prior to July 1, 1997. In July 1997, the GASB increased to seven members. Documents considered by the GASB after July 1, 1997 are cleared if at least four of the seven GASB members do not object. [Footnote renumbered, June 2004, to reflect conforming changes necessary due to the issuance of the AICPA Audit and Accounting Guide *State and Local Governments*.]

Introduction

.01 Some nongovernmental not-for-profit organizations (NPOs) and some state and local governmental entities,[1] such as governmental colleges and universities and governmental health care providers, solicit support through a variety of **fund-raising activities.**[2] These activities include direct mail, telephone solicitation, door-to-door canvassing, telethons, special events, and others. Sometimes fund-raising activities are conducted with activities related to other functions, such as **program activities** or supporting services, such as **management and general activities**.[3] Sometimes fund-raising activities include components that would otherwise be associated with program or supporting services, but in fact support fund raising.

.02 External users of financial statements—including contributors, creditors, accreditation agencies, and regulators—want assurance that fund-raising costs, as well as program costs and management and general costs, are stated fairly.

.03 In 1987, the AICPA issued Statement of Position (SOP) 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*.[4] SOP 87-2 required that all circumstances concerning informational materials and activities that include a fund-raising appeal be considered in accounting for **joint costs** of those materials and activities and that certain criteria be applied in determining whether joint costs of those materials and activities should be charged to fund raising or allocated to program or management and general. Those criteria include requiring verifiable indications of the reasons for conducting the activity, such as

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[1] This Statement of Position (SOP) uses the term *entity* to refer to both nongovernmental not-for-profit organizations (NPOs) and state and local governments.

[2] Terms that appear in the Glossary [paragraph .30] are set in **boldface type** the first time they appear.

[3] The functional classifications of fund raising, program, and management and general are discussed throughout this SOP for purposes of illustrating how the guidance in this SOP would be applied by entities that use those functional classifications. Some entities have a functional structure that does not include fund raising, program, or management and general, or that includes other functional classifications, such as **membership development**. This SOP is not intended to require reporting the functional classifications of fund raising, program, and management and general. In circumstances in which entities that have a functional structure that includes other functional classifications conduct joint activities, all costs of those joint activities should be charged to fund raising (or the category in which fund raising is reported—see the following two parenthetical sentences), unless the purpose, audience, and content of those joint activities are appropriate for achieving those other functions. (An example of an entity that reports fund raising in a category other than fund raising is a state and local governmental entity applying the accounting and financial reporting principles in the AICPA Industry Audit Guide *Audits of Colleges and Universities*, as amended by SOP 74-8. As discussed in paragraph D.5 of this SOP [paragraph .24], those entities are required to report fund raising as part of the "institutional support" function. See also footnote # to paragraph D.5.) [Footnote revised, June 2004, to reflect conforming changes necessary due to the issuance of GASB Statements No. 34 and No. 35.]

[4] In August 1996, the AICPA issued the Audit and Accounting Guide *Not-for-Profit Organizations*. The Guide supersedes SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, because the provisions of SOP 87-2 are incorporated into paragraphs 13.36 to 13.45 of *Not-for-Profit Organizations*. *Not-for-Profit Organizations* applies to all nongovernmental NPOs other than those required to follow the Audit and Accounting Guide *Health Care Organizations*. The discussion in this SOP of SOP 87-2 refers to both SOP 87-2 and the guidance included in paragraphs 13.36 to 13.45 of *Not-for-Profit Organizations*. Also, SOP 87-2 was not applicable to entities that are within the scope of Governmental Accounting Standards Board (GASB) Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*.

the content, audience, and action, if any, requested of the participant, as well as other corroborating evidence. Further, SOP 87-2 required that all joint costs of those materials and activities be charged to fund raising unless the appeal is designed to motivate its audience to action other than providing financial support to the organization.

.04 The provisions of SOP 87-2 have been difficult to implement and have been applied inconsistently in practice. (Appendix B [paragraph .22], "Background," discusses this further.)

.05 This SOP establishes financial accounting standards for accounting for **costs of joint activities**. In addition, this SOP requires financial statement disclosures about the nature of the activities for which joint costs have been allocated and the amounts of joint costs. Appendix F [paragraph .26] provides explanations and illustrations of some acceptable allocation methods.

Scope

.06 This SOP applies to all nongovernmental NPOs and all state and local governmental entities that solicit **contributions**.

Conclusions

Accounting for Joint Activities

.07 If the criteria of purpose, audience, and content are met, the costs of a **joint activity** that are identifiable with a particular function should be charged to that function and joint costs should be allocated between fund raising and the appropriate program or management and general function. If any of the criteria are not met, all costs of the joint activity should be reported as fund-raising costs, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity, subject to the exception in the following sentence. Costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should not be reported as fund raising.

Purpose

.08 The purpose criterion is met if the purpose of the joint activity includes accomplishing program or management and general functions. (Paragraphs .09 and .10 provide guidance that should be considered in determining whether the purpose criterion is met. Paragraph .09 provides guidance pertaining to program functions only. Paragraph .10 provides guidance pertaining to both program and management and general functions.)

.09 *Program functions*. To accomplish program functions, the activity should call for specific action by the audience that will **help accomplish the entity's mission**. For purposes of applying the guidance in this SOP, the following are examples of activities that do and do not call for specific action by the audience that will help accomplish the entity's mission:

- An entity's mission includes improving individuals' physical health. For that entity, motivating the audience to take specific action that will improve their physical health is a call for specific action by the audience that will help accomplish the entity's mission. An example of an activity that motivates the audience to take specific action that will improve their physical health is sending the audience a brochure that urges them to stop smoking and suggests specific methods, instructions, references, and resources that may be used to stop smoking.

- An entity's mission includes educating individuals in areas other than the causes, conditions, needs, or concerns that the entity's programs are designed to address (referred to hereafter in this SOP as "causes"). For that entity, educating the audience in areas other than causes or motivating the audience to otherwise engage in specific activities that will educate them in areas other than causes is a call for specific action by the audience that will help accomplish the entity's mission. Examples of entities whose mission includes educating individuals in areas other than causes are universities and possibly other entities. An example of an activity motivating individuals to engage in education in areas other than causes is a university inviting individuals to attend a lecture or class in which the individuals will learn about the solar system.
- Educating the audience about causes or motivating the audience to otherwise engage in specific activities that will educate them about causes is not a call for specific action by the audience that will help accomplish the entity's mission. Such activities are considered in support of fund raising. (However, some educational activities that might otherwise be considered as educating the audience about causes may implicitly call for specific action by the audience that will help accomplish the entity's mission. For example, activities that educate the audience about environmental problems caused by not recycling implicitly call for that audience to increase recycling. If the need for and benefits of the specific action are clearly evident from the educational message, the message is considered to include an implicit call for specific action by the audience that will help accomplish the entity's mission.)
- Asking the audience to make contributions is not a call for specific action by the audience that will help accomplish the entity's mission.

If the activity calls for specific action by the audience that will help accomplish the entity's mission, the guidance in paragraph .10 should also be considered in determining whether the purpose criterion is met.

.10 *Program and management and general functions*. The following factors should be considered, in the order in which they are listed,[5] to determine whether the purpose criterion is met:

a. *Whether **compensation or fees** for performing the activity are based on contributions raised.* The purpose criterion is *not* met if a majority of compensation or fees for any party's performance of

[5] In considering the guidance in paragraph .10, the factor in paragraph .10*a* (the compensation or fees test) is the preeminent guidance. If the factor in paragraph .10*a* is not determinative, the factor in paragraph .10*b* (whether a similar program or management and general activity is conducted separately and on a similar or greater scale) should be considered. If the factor in paragraph .10*b* is not determinative, the factor in paragraph .10*c* (other evidence) should be considered.

any component of the discrete joint activity varies based on contributions raised for that discrete joint activity.[6,7]

b. *Whether a similar program or management and general activity is conducted separately and on a similar or greater scale.* The purpose criterion is met if either of the following two conditions is met:

(1) *Condition 1*:

— The program component of the joint activity calls for specific action by the recipient that will help accomplish the entity's mission and

— A similar program component is conducted without the fund-raising component using the same **medium** and on a scale that is similar to or greater than the scale on which it is conducted with the fund raising.[8]

(2) *Condition 2*:

A management and general activity that is similar to the management and general component of the joint activity being accounted for is conducted without the fund-raising component using the same medium and on a scale that is similar to or greater than the scale on which it is conducted with the fund raising

If the purpose criterion is met based on the factor in paragraph .10*b*, the factor in paragraph .10*c* should not be considered.

c. *Other evidence*. If the factors in paragraph .10*a* or .10*b* do not determine whether the purpose criterion is met, other evidence may determine whether the criterion is met. All available evidence, both positive and negative, should be considered to determine whether, based on the weight of that evidence, the purpose criterion is met.

.11 The following are examples of indicators that provide evidence for determining whether the purpose criterion is met:

a. Evidence that the purpose criterion may be met includes—

- *Measuring program results and accomplishments of the activity*. The facts may indicate that the purpose criterion

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[6] Some compensation contracts provide that compensation for performing the activity is based on a factor other than contributions raised, but not to exceed a specified portion of contributions raised. For example, a contract may provide that compensation for performing the activity is $10 per contact hour, but not to exceed 60 percent of contributions raised. In such circumstances, compensation is not considered based on amounts raised, unless the stated maximum percentage is met. In circumstances in which it is not yet known whether the stated maximum percentage is met, compensation is not considered based on amounts raised, unless it is probable that the stated maximum percentage will be met.

[7] The *compensation or fees test* is a negative test in that it either (*a*) results in failing the purpose criterion or (*b*) is not determinative of whether the purpose criterion is met. Therefore, if the activity fails the purpose criterion based on this factor (the compensation or fees test), the activity fails the purpose criterion and the factor in paragraph .10*b* should not be considered. If the purpose criterion is not failed based on this factor, this factor is not determinative of whether the purpose criterion is met and the factor in paragraph .10*b* should be considered.

[8] Determining the scale on which an activity is conducted may be a subjective determination. Factors to consider in determining the scale on which an activity is conducted may include dollars spent, the size of the audience reached, and the degree to which the characteristics of the audience are similar to the characteristics of the audience of the activity being evaluated.

is met if the entity measures program results and accomplishments of the activity (other than measuring the extent to which the public was educated about causes).

- *Medium*. The facts may indicate that the purpose criterion is met if the program component of the joint activity calls for specific action by the recipient that will help accomplish the entity's mission and if the entity conducts the program component without a significant fund-raising component in a different medium. Also, the facts may indicate that the purpose criterion is met if the entity conducts the management and general component of the joint activity without a significant fund-raising component in a different medium.

b. Evidence that the purpose criterion may not be met includes—

- *Evaluation or compensation*. The facts may indicate that the purpose criterion is not met if (*a*) the evaluation of any party's performance of any component of the discrete joint activity varies based on contributions raised for that discrete joint activity or (*b*) some, but less than a majority, of compensation or fees for any party's performance of any component of the discrete joint activity varies based on contributions raised for that discrete joint activity.

c. Evidence that the purpose criterion may be either met or not met includes—

- *Evaluation of measured results of the activity*. The entity may have a process to evaluate measured program results and accomplishments of the activity (other than measuring the extent to which the public was educated about causes). If the entity has such a process, in evaluating the effectiveness of the joint activity, the entity may place significantly greater weight on the activity's effectiveness in accomplishing program goals or may place significantly greater weight on the activity's effectiveness in raising contributions. The former may indicate that the purpose criterion is met. The latter may indicate that the purpose criterion is not met.
- *Qualifications*. The qualifications and duties of those performing the joint activity should be considered.
  - — If a third party, such as a consultant or contractor, performs part or all of the joint activity, such as producing brochures or making telephone calls, the third party's experience and the range of services provided to the entity should be considered in determining whether the third party is performing fund-raising, program (other than educating the public about causes), or management and general activities on behalf of the entity.
  - — If the entity's employees perform part or all of the joint activity, the full range of their job

duties should be considered in determining whether those employees are performing fund-raising, program (other than educating the public about causes), or management and general activities on behalf of the entity. For example, (*a*) employees who are not members of the fund-raising department and (*b*) employees who are members of the fund-raising department but who perform non-fund-raising activities are more likely to perform activities that include program or management and general functions than are employees who otherwise devote significant time to fund raising.

- *Tangible evidence of intent*. Tangible evidence indicating the intended purpose of the joint activity should be considered. Examples of such tangible evidence include
  - — The entity's written mission statement, as stated in its fund-raising activities, bylaws, or annual report.
  - — Minutes of board of directors', committees', or other meetings.
  - — Restrictions imposed by donors (who are not related parties) on gifts intended to fund the joint activity.
  - — Long-range plans or operating policies.
  - — Written instructions to other entities, such as script writers, consultants, or list brokers, concerning the purpose of the joint activity, audience to be targeted, or method of conducting the joint activity.
  - — Internal management memoranda.

Audience

.12 A rebuttable presumption exists that the audience criterion is not met if the audience includes prior donors or is otherwise selected based on its ability or likelihood to contribute to the entity. That presumption can be overcome if the audience is also selected for one or more of the reasons in paragraph .13*a*, .13*b*, or .13*c*. In determining whether that presumption is overcome, entities should consider the extent to which the audience is selected based on its ability or likelihood to contribute to the entity and contrast that with the extent to which it is selected for one or more of the reasons in paragraph .13*a*, .13*b*, or .13*c*. For example, if the audience's ability or likelihood to contribute is a significant factor in its selection and it has a need for the action related to the program component of the joint activity, but having that need is an insignificant factor in its selection, the presumption would not be overcome.

.13 In circumstances in which the audience includes no prior donors and is not otherwise selected based on its ability or likelihood to contribute to the entity, the audience criterion is met if the audience is selected for one or more of the following reasons:

a. The audience's need to use or reasonable potential for use of the specific action called for by the program component of the joint activity

b. The audience's ability to take specific action to assist the entity in meeting the goals of the program component of the joint activity

c. The entity is required to direct the management and general component of the joint activity to the particular audience or the audience has reasonable potential for use of the management and general component

Content

.14 The content criterion is met if the joint activity supports program or management and general functions, as follows:

a. *Program*. The joint activity calls for specific action by the recipient that will help accomplish the entity's mission. If the need for and benefits of the action are not clearly evident, information describing the action and explaining the need for and benefits of the action is provided.

b. *Management and general*. The joint activity fulfills one or more of the entity's management and general responsibilities through a component of the joint activity.[9]

.15 Information identifying and describing the entity, causes, or how the contributions provided will be used is considered in support of fund raising.

Allocation Methods

.16 The cost allocation methodology used should be rational and systematic, it should result in an allocation of joint costs that is reasonable, and it should be applied consistently given similar facts and circumstances.

Incidental Activities

.17 Some fund-raising activities conducted in conjunction with program or management and general activities are incidental to such program or management and general activities. For example, an entity may conduct a fund-raising activity by including a generic message, "Contributions to Organization X may be sent to [*address*]" on a small area of a message that would otherwise be considered a program or management and general activity based on its purpose, audience, and content. That fund-raising activity likely would be considered incidental to the program or management and general activity being conducted. Similarly, entities may conduct program or management and general activities in conjunction with fund-raising activities that are incidental to such fund-raising activities. For example, an entity may conduct a program activity by including a generic program message such as "Continue to pray for [*a particular cause*]" on a small area of a message that would otherwise be considered fund raising based on its purpose, audience, and content. That program activity would likely be considered incidental to the fund-raising activity being conducted. Similarly, an entity may conduct a management and general activity by

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[9] Some states or other regulatory bodies require that certain disclosures be included when soliciting contributions. For purposes of applying the guidance in this SOP, communications that include such required disclosures are considered fund-raising activities and are not considered management and general activities.

including a brief management and general message—"We recently changed our phone number. Our new number is 123-4567"—on a small area of a message that would otherwise be considered a program or fund-raising activity based on its purpose, audience, and content. That management and general activity would likely be considered incidental to the program or fund-raising activity being conducted. In circumstances in which a fund-raising, program, or management and general activity is conducted in conjunction with another activity and is incidental to that other activity, and the conditions in this SOP for allocation are met, joint costs are permitted but not required to be allocated and may therefore be charged to the functional classification related to the activity that is not the incidental activity. However, in circumstances in which the program or management and general activities are incidental to the fund-raising activities, it is unlikely that the conditions required by this SOP to permit allocation of joint costs would be met.

Disclosures

.18 Entities that allocate joint costs should disclose the following in the notes to their financial statements:

a. The types of activities for which joint costs have been incurred

b. A statement that such costs have been allocated

c. The total amount allocated during the period and the portion allocated to each functional expense category

.19 This SOP encourages, but does not require, that the amount of joint costs for each kind of joint activity be disclosed, if practical.

Effective Date

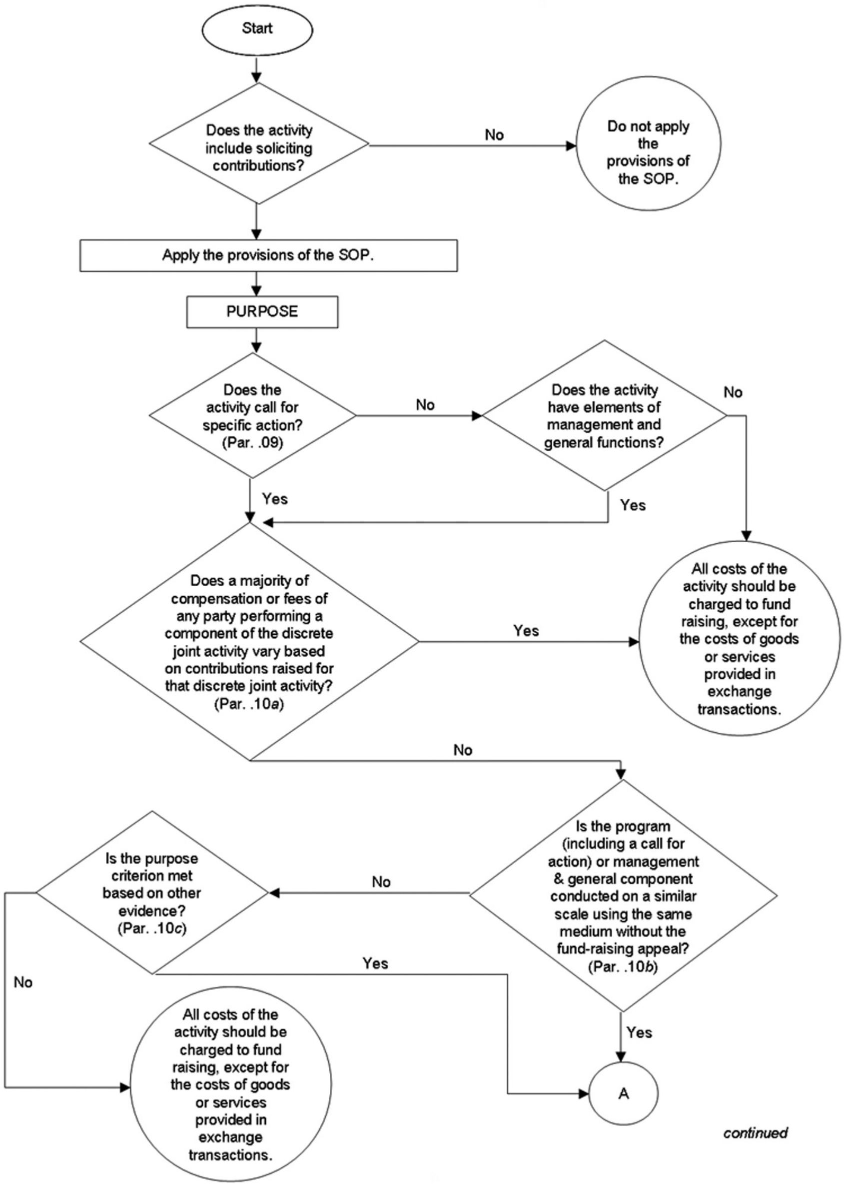
.20 This SOP is effective for financial statements for years beginning on or after December 15, 1998. Earlier application is encouraged in fiscal years for which financial statements have not been issued. If comparative financial statements are presented, retroactive application is permitted but not required.

The provisions of this Statement of Position need not be applied to immaterial items.

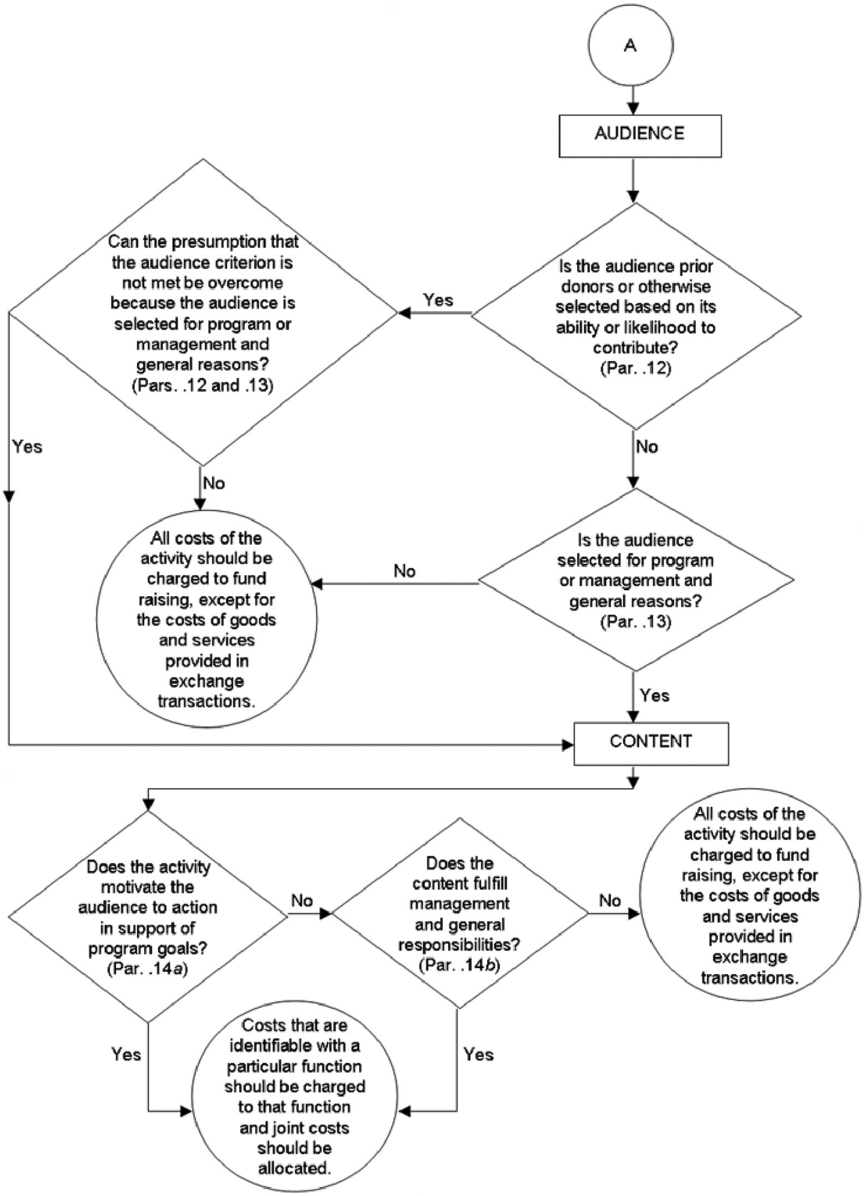
.21

Appendix A

Accounting for Joint Activities[10]



[10] Note: This flowchart summarizes certain guidance in this SOP and is not intended as a substitute for the SOP.


A
AUDIENCE
Is the audience prior donors or otherwise selected based on its ability or likelihood to contribute? (Par. .12)
Yes
Can the presumption that the audience criterion is not met be overcome because the audience is selected for program or management and general reasons? (Pars. .12 and .13)
Yes
No
No
All costs of the activity should be charged to fund raising, except for the costs of goods and services provided in exchange transactions.
No
Is the audience selected for program or management and general reasons? (Par. .13)
Yes
CONTENT
Does the activity motivate the audience to action in support of program goals? (Par. .14a)
No
Does the content fulfill management and general responsibilities? (Par. .14b)
No
All costs of the activity should be charged to fund raising, except for the costs of goods and services provided in exchange transactions.
Yes
Yes
Costs that are identifiable with a particular function should be charged to that function and joint costs should be allocated.

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Appendix B

Background

B.1. As stated in paragraph .04, the provisions of Statement of Position (SOP) 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, have been difficult to implement and applied inconsistently in practice. That difficulty has been due in part to the following:

- The second sentence of paragraph 1 of SOP 87-2 stated that "some of the costs incurred by such organizations are clearly identifiable with fundraising, such as the cost of fund-raising consulting services." It is unclear whether activities that would otherwise be considered program activities should be characterized as program activities if they are performed or overseen by professional fund raisers. Also, it is unclear whether activities would be reported differently (for example, as program rather than fund raising) depending on whether the fund-raising consultant is compensated by a predetermined fee or by some other method, such as a percentage of contributions raised.
- SOP 87-2 was unclear about whether allocation of costs to fund-raising expense is required if the activity for which the costs were incurred would not have been undertaken without the fund-raising component.
- SOP 87-2 defined joint costs through examples, and it is therefore unclear what kinds of costs were covered by SOP 87-2. For example, it is unclear whether salaries and indirect costs can be joint costs.
- Some believe the guidance in SOP 87-2 was inadequate to determine whether joint activities, such as those that request contributions and also list the warning signs of a disease, are designed to motivate their audiences to action other than to provide contributions to the entity. It is unclear what attributes the targeted audience should possess in order to conclude that a program function is being conducted.

B.2. In 1992, the Accounting Standards Executive Committee (AcSEC) undertook a project to supersede SOP 87-2, to provide clearer guidance than that provided by SOP 87-2, as well as to provide guidance that would improve on the guidance in SOP 87-2. In September 1993, AcSEC released an exposure draft of a proposed SOP, *Accounting for Costs of Materials and Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include a Fund-Raising Appeal*, for public comment. AcSEC received more than 300 comment letters on the exposure draft. AcSEC redeliberated the issues based on the comments received.

B.3. In 1996, after redeliberating the issues based on the comments received and making certain revisions to the draft SOP, AcSEC conducted a field test of the draft SOP. The objectives of the field test were to determine whether the provisions of the draft SOP were sufficiently clear and definitive to generate consistent and comparable application of the SOP. Based on the field test results, AcSEC concluded that the provisions of the draft SOP, with certain revisions, were sufficiently clear and definitive to generate consistent and comparable application of the SOP.

B.4. Some respondents who commented on the exposure draft, as well as some interested parties who followed the project through its due process subsequent to the exposure draft, commented that the SOP should be reexposed for public comment. Reasons cited include:

- Approximately three years had passed between the end of the comment period and AcSEC's decision to issue the SOP.
- AcSEC made significant revisions to the SOP subsequent to releasing the exposure draft for comment.

Considering whether a proposed standard should be reexposed for public comment is inherently a subjective process. Factors that AcSEC considered include—

- The significance of changes made to the exposure draft and whether those changes result in guidance that the public did not have an opportunity to consider.
- Whether the scope was revised in such a way that affected entities did not have an opportunity to comment.
- New information about or changes in the nature of the transactions being considered, practice, or other factors.

AcSEC believes that the length of time between exposure and final issuance is not pertinent to whether the SOP should be reexposed for public comment.

B.5. Based on consideration of the factors identified, AcSEC believes that the SOP should not be reexposed for public comment. AcSEC notes that although the SOP has been revised based on comments received on the exposure draft, those revisions do not change the overall model in the SOP. Those revisions were made primarily to clarify the SOP and improve its operationality. Further, AcSEC believes that the project received a high level of attention from interested parties. AcSEC provided working drafts to interested parties and those parties provided input throughout the process, up to and including the Financial Accounting Standard Board's and the Governmental Accounting Standards Board's clearance of the SOP for issuance.

B.6. Appendix C [paragraph .23] discusses the key issues in the exposure draft and comments received on those issues, as well as the basis for AcSEC's conclusions on those and certain other issues.

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Appendix C

Basis for Conclusions

C.1. This section discusses considerations that were deemed significant by members of the Accounting Standards Executive Committee (AcSEC) in reaching the conclusions in this Statement of Position (SOP). It includes reasons for accepting certain views and rejecting others. Individual AcSEC members gave greater weight to some factors than to others.

Overall Framework

C.2. This SOP uses the model in SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, as a starting point and clarifies guidance that was unclear, provides more detailed guidance, revises some guidance, and expands the scope of costs covered to include all costs of joint activities. The model established by SOP 87-2 was to account for joint costs as fund raising unless an entity could demonstrate that a program or management and general function had been conducted. SOP 87-2 used verifiable indications of the reasons for conducting the activity, such as content, audience, the action requested, if any, and other corroborating evidence as a basis for determining whether a program or management and general function had been conducted.

C.3. On an overall basis, the majority of respondents who commented on the September 1993 exposure draft of a proposed SOP, *Accounting for Costs of Materials and Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include a Fund-Raising Appeal*, opposed it, for various reasons, including the following:

- The guidance in SOP 87-2 is operational, results in sound financial reporting, and should be retained.
- The guidance in SOP 87-2 should be retained but clarified.
- The guidance proposed in the exposure draft should be revised. (Some commented that it overstates fund raising; others commented that it understates fund raising.)

C.4. AcSEC concluded that it supports the model in the exposure draft, subject to certain revisions. AcSEC believes that this SOP provides clear, detailed accounting guidance that, when applied, will increase comparability of financial statements. Those statements will also include more meaningful disclosures without incurring increased costs.

C.5. Some respondents commented that the model in the exposure draft would adversely affect entities both financially and operationally. Various reasons were given, including the following:

- It would inhibit the ability of entities, particularly small entities and entities that raise contributions through direct solicitations, to generate the necessary revenue to perform their program services.
- Most entities would not meet the criteria in this SOP for reporting costs of joint activities as program or management and general, because they must combine their mission statements, public information and education, and fund-raising appeals due to a lack

of resources. Some noted that this may result in unsatisfactory ratings from public watchdog groups.

AcSEC did not find these arguments compelling. This SOP provides accounting guidance; it provides no guidance concerning how entities should undertake their activities. Also, this SOP does not prohibit allocation merely because activities carrying out different functions are combined. In fact, this SOP provides guidance for reporting costs as program or management and general in circumstances in which those activities are combined with fund-raising. Moreover, actions taken by financial statement users are not the direct result of the requirements of this SOP. Rather, those actions may result from more relevant and useful information on which to base decisions.

C.6. Some respondents commented that the exposure draft is biased toward reporting expenses as fund raising. AcSEC believes that determining whether the costs of joint activities should be classified as program, management and general, or fund raising sometimes is difficult, and such distinctions sometimes are subject to a high degree of judgment. AcSEC believes that external financial statement users focus on and have perceptions about amounts reported as program, management and general, and fund raising. That focus and those perceptions provide incentives for entities to report expenses as program or management and general rather than fund raising. Therefore, in circumstances in which joint activities are conducted, a presumption exists that expenses should be reported as fund raising rather than as program or management and general. The criteria in this SOP provide guidance for entities to overcome that presumption.

Accounting for Joint Activities

C.7. This SOP requires that if any of the criteria of purpose, audience, and content are not met, all costs of the activity should be reported as fund raising, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity, subject to the exception in the following sentence. Costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should not be reported as fund raising. (This SOP expands on the model established by SOP 87-2 by including all costs of joint activities other than costs of goods or services provided in exchange transactions, rather than merely joint costs.) AcSEC believes that the criteria of purpose, audience, and content are each relevant in determining whether a joint activity should be reported as fund raising, program, or management and general because each provides significant evidence about the benefits expected to be obtained by undertaking the activity.

C.8. Some respondents commented that reporting costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity as fund raising is misleading and that the scope of the SOP should include only joint costs of joint activities. Some commented that reporting costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity as fund raising conflicts with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 117, *Financial Statements of Not-for-Profit Organizations*, which defines fund raising, program, and management and general and requires not-for-profit organizations (NPOs) to report information about expenses using those functional classifications.

C.9. AcSEC believes that the purpose for which costs other than joint costs are incurred may be fund raising, program, or management and general, depending on the context in which they are used in the activity undertaken. For example, a program-related pamphlet may be sent to an audience in need of the program. In that context, the pamphlet is used for program purposes. However, in order to demonstrate to potential donors that the entity's programs are worthwhile, that same pamphlet may be sent to an audience that is likely to contribute, but that has no need or reasonable potential for use of the program. In that context, the pamphlet is used for fund raising. AcSEC believes this broader scope will result in more comparability and more meaningful financial reporting by covering all costs of activities that include fund raising and by assigning those costs to the function for which they are incurred, consistent with the guidance in Statement No. 117.

C.10. AcSEC believes that costs of goods or services provided in exchange transactions should not be charged to fund raising because those costs are incurred in exchange for revenues other than contributions.

Criteria of Purpose, Audience, and Content

Call For Action

C.11. The definition of *program* in FASB Statement No. 117 includes public education. As noted in paragraph C.6, AcSEC believes that in circumstances in which joint activities are conducted, a presumption exists that expenses should be reported as fund raising rather than as program or management and general. AcSEC believes that in order to overcome that presumption, it is not enough that (*a*) the purpose of the activity include educating the public about causes, (*b*) the audience has a need or reasonable potential for use of any educational component of the activity pertaining to causes, or (*c*) the audience has the ability to assist the entity in meeting the goals of the program component of the activity by becoming educated about causes. Therefore, AcSEC concluded that for purposes of this SOP, in order to conclude that the criteria of purpose, audience, and content are met program activities are required to call for specific action by the recipient (other than becoming educated about causes) that will help accomplish the entity's mission. As discussed in paragraph .09, in certain circumstances educational activities may call for specific action by the recipient that will help accomplish the entity's mission.

Purpose

C.12. AcSEC believes meeting the purpose criterion demonstrates that the purpose of the activity includes accomplishing program or management and general functions. Inherent in the notion of a joint activity is that the activity has elements of more than one function. Accordingly, the purpose criterion provides guidance for determining whether the purpose of the activity includes accomplishing program or management and general functions in addition to fund raising.

Compensation and Evaluation Tests

C.13. The exposure draft proposed that all costs of the joint activity should be charged to fund raising if (*a*) substantially all compensation or fees for performing the activity are based on amounts raised or (*b*) the evaluation of the party performing the activity is based on amounts raised. Some respondents commented that basing the method of compensation or evaluating the performance of the party performing the activity based on contributions raised should not lead to the conclusion that all costs of the activity should be charged to fund raising. Others commented that the method of compensation is unrelated to whether the purpose criterion is met. The reasons given included the following:

- It is counterintuitive to imply that those performing multipurpose activities that include fund raising would not be compensated or evaluated based on amounts raised.
- Such guidance would create a bias toward entities that use employees to raise contributions and against entities that hire professional fund raisers and public relations firms and is therefore not neutral.

Some respondents gave examples of circumstances in which substantially all compensation is based on contributions raised and asserted that the activity was nevertheless a program activity. In each of those examples, AcSEC considered all the facts presented and concluded that the activity was fund raising.

C.14. AcSEC continues to support the spirit of the proposed guidance, because AcSEC believes that basing a majority of compensation on funds raised is persuasive evidence that the activity is a fund-raising activity. Nevertheless, AcSEC believes that the proposed guidance was unclear and would be difficult to implement, primarily because of the broad definition of "based on contributions raised" included in the glossary of the exposure draft. In connection with that issue, AcSEC was concerned that any joint activities performed by a fund-raising department or by individuals whose duties include fund raising, such as executive officers of small NPOs who are employed based on their ability to raise contributions, would be required to be reported as fund raising because the compensation of the parties performing those activities is based on amounts raised. Also, AcSEC had concerns that it would be difficult to determine whether fixed contract amounts were negotiated based on expected contributions. Therefore, AcSEC concluded that the compensation test should be revised to provide that the purpose criterion is not met if a majority of compensation or fees for any party's performance of any component of the discrete joint activity varies based on contributions raised for that discrete joint activity. AcSEC believes that guidance is sound and is operational.

C.15. AcSEC believes that the guidance in paragraph .10*a* is not biased against entities that hire professional fund raisers, because it applies to the entity's employees as well as professional fund raisers. For example, if a majority of an employee's compensation or fees for performing a component of a discrete joint activity varies based on contributions raised for that discrete joint activity, the purpose criterion is not met.

Similar Function-Similar Medium Test

C.16. Some respondents misinterpreted the exposure draft as providing that, in order to meet the purpose criterion, the program or management and general activity must be conducted without the fund-raising component, using the same medium and on a scale that is similar to or greater than the program or management and general component of the activity being accounted for. That was not a requirement proposed by the exposure draft. The exposure draft proposed that meeting that condition would result in meeting the purpose criterion. Failing the criterion merely leads to consideration of other evidence, such as the indicators in paragraph .11. AcSEC has revised the SOP to state this more clearly.

Other Evidence

C.17. The compensation test and the similar function-similar medium test may not always be determinative because the attributes that they consider may not be present. Therefore, this SOP includes indicators that should be considered in circumstances in which the compensation test and the similar function-similar medium test are not determinative. The nature of those indicators is such that they may be present in varying degrees. Therefore, all available evidence, both positive and negative, should be considered to determine whether, based on the weight of that evidence, the purpose criterion is met.

Audience

C.18. The exposure draft proposed that if the audience for the materials or activities is selected principally on its ability or likelihood to contribute, the audience criterion is not met and all the costs of the activity should be charged to fund raising. Further, the exposure draft proposed that if the audience is selected principally based on its need for the program or because it can assist the entity in meeting its program goals other than by financial support provided to the entity, the audience criterion is met. Some respondents commented that that audience criterion is too narrow, because it is based on the principal reason for selecting the audience. They asserted that for some activities no principal reason exists for selecting an audience; entities select the audience for those activities for multiple reasons, such as both the audience's ability to contribute and its ability to help meet program goals. Some commented that for some activities, entities select audiences that have provided past financial support because, by providing financial support, those audiences have expressed an interest in the program.

C.19. AcSEC believes that meeting the audience criterion should demonstrate that the audience is selected because it is a suitable audience for accomplishing the activity's program or management and general functions. Therefore, the reasons for selecting the audience should be consistent with the program or management and general content of the activity. However, AcSEC believes it is inherent in the notion of joint activities that the activity has elements of more than one function, including fund raising, and acknowledges that it may be difficult to determine the principal reason for selecting the audience. Accordingly, AcSEC concluded that if the audience includes prior donors or is otherwise selected based on its ability or likelihood to contribute, a rebuttable presumption should exist that the audience was selected to raise funds. AcSEC believes that the reasons for selecting the audience that can overcome that presumption, which are included in paragraph .13 of this SOP, demonstrate that the audience is selected because it is a suitable audience for accomplishing the activity's program or management and general functions based on the program or management and general content of the activity.

Content

C.20. AcSEC believes that meeting the content criterion demonstrates that the content of the activity supports program or management and general functions. AcSEC believes that accounting guidance should not impose value judgments about whether the entity's mission, programs, and responsibilities are worthwhile. Therefore, whether the content criterion is met depends on the relationship of the content to the entity's mission, programs, and management and general responsibilities.

C.21. Paragraph .14 provides that, to meet the content criterion, program activities should call for specific action by the recipient that will help accomplish the entity's mission. The exposure draft proposed that slogans, general calls to prayer, and general calls to protest do not meet the content criterion; some respondents disagreed. AcSEC concluded that this SOP should be silent concerning whether slogans, general calls to prayer, and general calls to protest are calls to action that meet the content criterion. AcSEC believes that determining whether those items are calls to action that meet the content criterion requires judgments based on the particular facts and circumstances.

C.22. Some respondents commented that educating the public about causes without calling for specific action should satisfy the content criterion. They noted that this is particularly relevant for NPOs subject to Internal Revenue Code (IRC) Section 501(c)4, because those NPOs are involved in legislative reform. Also, some noted that it may be the entity's mission or goal to educate the public about causes. They believe that, in those cases, the NPO's program is to educate the public about causes without necessarily calling for specific action by the recipient.

C.23. As discussed in paragraph C.11, AcSEC concluded that education that does not motivate the audience to action is in fact done in support of fund raising. However, this SOP acknowledges that some educational messages motivate the audience to specific action, and those messages meet the content criterion. AcSEC believes that that provision will result in the activities of some NPOs subject to IRC Section 501(c)4 (and some other entities, whose mission or goal is to educate the public) meeting the content criterion.

C.24. Paragraph .13*c* provides that one way that the audience criterion is met is if the entity is required to direct the management and general component of the activity to the particular audience. Further, as discussed in paragraph D.13, in *Discussion of Conclusions*, an audience that includes prior donors and is selected because the entity is required to send them certain information to comply with requirements of the Internal Revenue Service (IRS) is an example of an audience that is selected because the entity is required to direct the management and general component of the activity to that audience. Paragraph .14*b* provides that one way that the content criterion is met is if the activity fulfills one or more of the entity's management and general responsibilities through a component of the joint activity. However, footnote 9 to paragraph .14*b* provides that disclosures made when soliciting contributions to comply with requirements of states or other regulatory bodies are considered fund-raising activities, and are not considered management and general activities. AcSEC considered whether it is inconsistent to conclude both that (*a*) activities conducted to comply with requirements of regulatory bodies concerning contributions that have been received are management and general activities, and that (*b*) activities conducted to comply with requirements of regulatory bodies concerning soliciting contributions are fund-raising activities. AcSEC believes that those provisions are not inconsistent. AcSEC believes there is a distinction between (*a*) requirements that must be met as a result of receiving contributions and (*b*) requirements that must be met in order to solicit contributions. AcSEC believes that activities that are undertaken as a result of receiving contributions are management and general activities while activities that are undertaken in order to solicit contributions are fund-raising activities.

Incidental Activities

C.25. Many entities conduct fund-raising activities in conjunction with program or management and general activities that are incidental to such program or management and general activities. Similarly, entities may conduct program or management and general activities in conjunction with fund-raising activities that are incidental to such fund-raising activities. Such efforts may be a practical and efficient means for entities to conduct activities, although the principal purpose of the activity may be to fulfill either fund-raising, program, or management and general functions. The exposure draft proposed that incidental activities need not be considered in applying this SOP. Some respondents disagreed with that guidance, while others commented that it was confusing. AcSEC continues to support that guidance. AcSEC believes that guidance is necessary to avoid requiring complex allocations in circumstances in which the criteria of purpose, audience, and content are met but the activity is overwhelmingly either fund raising, program, or management and general.

Allocation Methods

C.26. Respondents had various comments concerning allocation methods, including the following:

- The SOP should focus on allocation methods rather than on circumstances in which entities should allocate.
- The SOP should prescribe allocation methods.
- The approach taken in the SOP—discussing, rather than requiring or prohibiting allocation methods—is sound.
- Certain allocation methods should be prohibited.
- The SOP should set maximum allocation percentages.

AcSEC believes that no particular allocation method or methods are necessarily more desirable than other methods in all circumstances. Therefore, this SOP neither prescribes nor prohibits any particular allocation methods. AcSEC believes entities should apply the allocation methods that result in the most reasonable cost allocations for their activities. Appendix F [paragraph .26] of this SOP illustrates several allocation methods, any one of which may result in a reasonable or unreasonable allocation of costs in particular circumstances. The methods illustrated are not the only acceptable methods. However, AcSEC believes that the methods illustrated in this SOP are among those most likely to result in meaningful cost allocations.

C.27. Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*, states in paragraph 7 that "the term *accounting principle* includes 'not only accounting principles and practices but also the methods of applying them.'" APB Opinion 20 also states in paragraphs 15 and 16 that

> . . . In the preparation of financial statements there is a presumption that an accounting principle once adopted should not be changed in accounting for events and transactions of a similar type....The presumption that an entity should not change an accounting principle may be overcome only if the enterprise justifies the use of an alternative acceptable accounting principle [*allocation method*] on the basis that it is preferable.

A change in cost allocation methodology may be a change in accounting principle for entities covered by this SOP. Accordingly, paragraph .16 of this SOP provides that the cost allocation methodology used should be applied consistently, given similar facts and circumstances.

Disclosures

C.28. Respondents made various comments concerning the required and encouraged disclosures, including recommendations for additional disclosures and recommendations that certain disclosures be deleted. AcSEC was not persuaded that the costs of the other disclosures recommended by respondents are justified by their benefits. AcSEC believes that, with the exception of one disclosure, the disclosures prescribed by the exposure draft provide relevant information about the kinds of activities for which joint costs have been incurred and the manner in which those costs are reported in the financial statements. In considering disclosures proposed by the exposure draft about the allocation method, AcSEC observed that there are no requirements to disclose methods of allocating other expenses and questioned the utility of disclosing the allocation method in this circumstance. AcSEC concluded that the requirement to disclose the allocation method should be deleted.

C.29. Paragraph .19 encourages, but does not require, certain disclosures. AcSEC believes those disclosures provide useful information but that they should be encouraged rather than required because the costs of making them may not be justified by the benefits in all cases.

Effective Date

C.30. Some respondents commented that the effective date should be deferred. AcSEC believes that the accounting systems required to implement this SOP are already in place and that implementation should be relatively straightforward. However, AcSEC acknowledges that some entities may change their operations based on the reporting that would result from this SOP. Therefore, AcSEC concluded that this SOP should be effective for financial statements for years beginning on or after December 15, 1998.

Cost-Benefit

C.31. Some respondents commented that the guidance would increase record keeping costs. AcSEC believes that implementing this SOP will not significantly increase record keeping costs, which are primarily the costs of documenting reasons for undertaking joint activities. Further, AcSEC believes that the costs of making the disclosures required by this SOP should be minimal, because entities should already have the information that is required to be disclosed. AcSEC believes that implementing this SOP will result in more relevant, meaningful, and comparable financial reporting and that the cost of implementing this SOP will be justified by its benefits.

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Appendix D

Discussion of Conclusions

Scope

D.1. This Statement of Position (SOP) applies only to costs of joint activities. It does not address allocations of costs in other circumstances.

Reporting Models and Related Requirements

D.2. Paragraph 26 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 117, *Financial Statements of Not-for-Profit Organizations*, specifies that a statement of activities or notes to the financial statements should provide information about expenses reported by their functional classification, such as major classes of program services and supporting activities. Paragraph 13.34 of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations* provides that the financial statements of not-for-profit organizations (NPOs) should disclose the total fund-raising expenses. [Revised, June 2004, to reflect conforming changes necessary due to conforming changes made to the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*.]

D.3. Governmental Accounting Standards Board (GASB) Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*, provides that governmental entities should not change their accounting and financial reporting to apply the provisions of FASB Statements No. 116, *Accounting for Contributions Received and Contributions Made*, and No. 117. GASB Statement No. 29 permits governmental entities that have applied the accounting and financial reporting principles in SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*, or in the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations* modified by all applicable FASB pronouncements issued through November 30, 1989, and by most applicable GASB pronouncements) to continue to do so, pending GASB pronouncements on the accounting and financial reporting model for governmental entities. Alternatively, those governmental entities are permitted to change to the current governmental financial reporting model.[‡]

D.4. GASB Statement No. 15, *Governmental College and University Accounting and Financial Reporting Models*, requires governmental colleges and universities to use one of two accounting and financial reporting models. One model, referred to as the "AICPA College Guide Model," encompasses the accounting and financial reporting guidance in the 1973 AICPA Industry Audit Guide *Audits of Colleges and Universities*, as amended by SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities*, and as modified by applicable FASB pronouncements issued through November 30, 1989, and all

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[‡] GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, supersedes the provisions of GASB Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*, relating to the use of the AICPA Not-for-Profit model. See GASB Statement No. 34, including paragraph 147. The AICPA Audit and Accounting Guide *State and Local Governments* provides guidance on the application of this SOP to state and local governments. [Footnote revised, June 2004, to reflect conforming changes necessary due to the issuance of GASB Statement No. 34.]

applicable GASB pronouncements. (The other model, referred to as the "Governmental Model," is based on the pronouncements of the National Council on Governmental Accounting [NCGA] and the GASB.)||

D.5. For state and local governmental entities, some are required to report expenses by function using the functional classifications of program, management and general, and fund raising. Other state and local governmental entities that report expenses or expenditures by function have a functional structure that does not include fund raising, program, or management and general. Still other state and local governmental entities do not report expenses or expenditures by function. Examples of those various reporting requirements are as follows:#

- Entities applying the accounting and financial reporting principles in the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations*, as well as those that follow SOP 78-10 and that receive significant amounts of contributions from the public, are required to report separately the costs of the fund-raising, program, and management and general functions.
- Entities applying the accounting and financial reporting principles in the AICPA Industry Audit Guide *Audits of Colleges and Universities*, as amended by SOP 74-8, are required to report fund raising as part of the "institutional support" function.

D.6. As discussed in footnote 3 to paragraph .01 of this SOP, this SOP is not intended to require reporting the functional classifications of fund raising, program, and management and general. Rather, those functional classifications are discussed throughout this SOP for purposes of illustrating how the guidance in this SOP would be applied by entities that use those functional classifications. Entities that do not use the functional classifications of fund raising, program, and management and general should apply the guidance in this SOP for purposes of accounting for joint activities, using their reporting model. For example, some entities may conduct membership-development activities. As discussed in the Glossary [paragraph .30] of this SOP, if there are no significant benefits or duties connected with membership, the substance of the membership-development activities may, in fact, be fund raising. In such circumstances, the costs of those activities should be charged to fund raising. To the extent that member benefits are received, membership is an exchange transaction. In circumstances in which membership development is in part soliciting revenues from exchange transactions and in part soliciting contributions and the purpose, audience, and content of the activity are appropriate for achieving membership development, joint costs should be allocated between fund raising and the exchange transaction.

|| GASB Statement No. 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities*, supersedes GASB Statement No. 15, *Governmental College and University Accounting and Financial Reporting Models*. See GASB Statements No. 34 and No. 35. The AICPA Audit and Accounting Guide *State and Local Governments* provides guidance on the application of this SOP to governmental (public) colleges and universities. [Footnote revised, June 2004, to reflect conforming changes necessary due to the issuance of GASB Statement No. 35.]

This discussion is no longer applicable. See footnotes ‡ and || in paragraphs D.3 and D.4, respectively. [Footnote added, June 2004, to reflect conforming changes necessary due to the issuance of GASB Statements No. 34 and No. 35.]

Assigning Costs of Joint Activities

D.7. Paragraph .07 provides: "If the criteria of purpose, audience, and content are met, the costs of a joint activity that are identifiable with a particular function should be charged to that function and joint costs should be allocated between fund raising and the appropriate program or management and general function. If any of the criteria are not met, all costs of the joint activity should be reported as fund-raising costs, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity...." For example, if the criteria are met, the costs of materials that accomplish program goals and that are unrelated to fund raising, such as the costs of a program-related pamphlet included in a joint activity, should be charged to program, while joint costs, such as postage, should be allocated between fund raising and program. However, if the pamphlet is used in fund-raising packets and the criteria are not met, the costs of the pamphlets used in the fund-raising packets, as well as the joint costs, should be charged to fund raising. (If some pamphlets are used in program activities that include no fund raising, the cost of the pamphlets used in those separate program activities that include no fund raising should be charged to program.)

Educational Activities

D.8. Some entities have missions that include educating the public (students) in areas other than causes. Paragraph .09 provides that, for those entities, educating the audience in areas other than causes or motivating the audience to engage in specific activities, such as attending a lecture or class, that will educate them in areas other than causes is considered a call for specific action by the recipients that will help accomplish the entity's mission. Educating the audience about causes or motivating the audience to engage in specific activities that will educate them about causes without educating them in other subjects is not considered a call for specific action by the audience that will help accomplish the entity's mission. An example of a lecture or class that will educate students in an area other than causes is a lecture on the nesting habits of the bald eagle, given by the Save the Bald Eagle Society, an NPO whose mission is to save the bald eagle from extinction and educate the public about the bald eagle. An example of a lecture or class that will address particular causes is a lecture by the Bald Eagle Society on the potential extinction of bald eagles and the need to raise contributions to prevent their extinction. For purposes of applying the guidance in this SOP, motivating the audience to attend a lecture on the nesting habits of the bald eagle is a call for specific action that will help accomplish the entity's mission. If the lecture merely addresses the potential extinction of bald eagles and the need to raise contributions to prevent their extinction, without addressing the nesting habits of the bald eagle, motivating the audience to attend the lecture is not considered a call for specific action by the recipient that will help accomplish the entity's mission.

D.9. AcSEC notes that most transactions in which a student attends a lecture or class are exchange transactions and are not joint activities. Such transactions are joint activities only if the activity includes fund raising.

Audience

D.10. Paragraph .12 provides that a rebuttable presumption exists that the audience criterion is not met if the audience includes prior donors or is otherwise selected based on its ability or likelihood to contribute to the entity. That presumption can be overcome if the audience is also selected for the program or management and general reasons specified in paragraph .13. Further, paragraph .12 provides that in determining whether that presumption is overcome, entities should consider the extent to which the audience is selected based on its ability or likelihood to contribute to the entity and contrast that with the extent to which it is selected for the reasons that may overcome that presumption. Some organizations conduct joint activities that are special events, such as symposia, dinners, dances, and theater parties, in which the attendee receives a direct benefit (for example, a meal or theater ticket) and for which the admission price includes a contribution. For example, it may cost $500 to attend a dinner with a fair value of $50. In that case, the audience is required to make a $450 contribution in order to attend. In circumstances in which the audience is required to make a contribution to participate in a joint activity, such as attending a special event, the audience's ability or likelihood to contribute is a significant factor in its selection. Therefore, in circumstances in which the audience is required to make a contribution to participate in a joint activity, the extent to which the audience is selected for the program or management and general reasons in paragraph .13 must be overwhelmingly significant in order to rebut the presumption that the audience criterion is not met.

D.11. The source of the names and the characteristics of the audience should be considered in determining the reason for selecting the audience. Some entities use lists compiled by others to reach new audiences. The source of such lists may indicate the purpose or purposes for which they were selected. For example, lists acquired from entities with similar or related programs are more likely to meet the audience criterion than are lists acquired from entities with dissimilar or unrelated programs. Also, the characteristics of those on the lists may indicate the purpose or purposes for which they were selected. For example, a list based on a consumer profile of those who buy environmentally friendly products may be useful to an entity whose mission addresses environmental concerns and could therefore indicate that the audience was selected for its ability to take action to assist the entity in meeting program goals. However, a list based on net worth would indicate that the audience was selected based on its ability or likelihood to contribute, unless there was a correlation between net worth and the program or management and general components of the activity.

D.12. Some audiences may be selected because they have an interest in or affinity to the program. For example, homeowners may have an interest in the homeless because they are sympathetic to the plight of the homeless. Nevertheless, including homeowners in the audience of a program activity to provide services to the homeless would not meet the audience criterion, because they do not have a need or reasonable potential for use of services to the homeless.

D.13. Paragraph .13*c* provides that the audience criterion is met if the entity is required to direct the management and general component of the joint activity to the particular audience or the audience has reasonable potential for use of the management and general component. An example of a joint activity in which the audience is selected because the entity is required to direct the management and general component of the joint activity to the particular audience is an activity in which the entity sends a written acknowledgment or other information to comply with requirements of the Internal Revenue Service to prior donors and includes a request for contributions. An example of a joint activity in which the audience is selected because the audience has reasonable potential for use of the management and general component is an activity in which the entity sends its annual report to prior donors and includes a request for contributions.

Content

D.14. Paragraph .14 provides that, to meet the content criterion, program activities should call for specific action by the recipient that will help accomplish the entity's mission. As discussed in the Glossary [paragraph .30], the action should benefit the recipient or society. Examples of actions that benefit the recipient (such as by improving the recipient's physical, mental, emotional, or spiritual health and well-being) or society (such as by addressing societal problems) include the following:

a. Actions that benefit the recipient:

- *Stop smoking*. Specific methods, instructions, references, and resources should be suggested.
- *Do not use alcohol or drugs*. Specific methods, instructions, references, and resources should be suggested.

b. Actions that benefit society:

- *Write or call*. The party to communicate with and the subject matter to be communicated should be specified.
- *Complete and return the enclosed questionnaire*. The results of the questionnaire should help the entity achieve its mission. For example, if the entity discards the questionnaire, it does not help the entity achieve its mission.
- *Boycott*. The particular product or company to be boycotted should be specified.

D.15. Paragraph .14*b* provides that to meet the content criterion, management and general functions are required to fulfill one or more of the entity's management and general responsibilities through a component of the joint activity. Some states or other regulatory bodies require that certain disclosures be included when soliciting contributions. Paragraph .14, footnote 9, of this SOP provides that for purposes of applying the guidance in this SOP, communications that include such required disclosures are considered fund-raising activities and are not considered management and general activities. Some examples of such disclosures include the following:

- Information filed with the attorney general concerning this charitable solicitation may be obtained from the attorney general of [*the state*] by calling 123-4567. Registration with the attorney general does not imply endorsement.
- A copy of the registration and financial information may be obtained from the Division of Consumer Services by calling toll-free, within [*the state*], 1-800-123-4567. Registration does not imply endorsement, approval, or recommendation by [*the state*].
- Information about the cost of postage and copying, and other information required to be filed under [*the state*] law, can be obtained by calling 123-4567.
- The organization's latest annual report can be obtained by calling 123-4567.

Allocation Methods

D.16. Paragraph .16 of this SOP states, "The cost allocation methodology used should be rational and systematic, it should result in an allocation of joint costs that is reasonable, and it should be applied consistently given similar facts and circumstances." The allocation of joint costs should be based on the degree to which costs were incurred for the functions to which the costs are allocated (that is, program, management and general, or fund raising). For purposes of determining whether the allocation methodology for a particular joint activity should be consistent with methodologies used for other particular joint activities, facts and circumstances that may be considered include factors related to the content and relative costs of the components of the activity. The audience should not be considered in determining whether the facts and circumstances are similar for purposes of determining whether the allocation methodology for a particular joint activity should be consistent with methodologies used for other particular joint activities.

Practicability of Measuring Joint Costs

D.17. The Glossary [paragraph .30] of this SOP includes a definition of joint costs. Some costs, such as utilities, rent, and insurance, commonly referred to as indirect costs, may be joint costs. For example, the telephone bill for a department that, among other things, prepares materials that include both fund-raising and program components may commonly be referred to as an indirect cost. Such telephone bills may also be joint costs. However, for some entities, it is impracticable to measure and allocate the portion of the costs that are joint costs. Considerations about which joint costs should be measured and allocated, such as considerations about materiality and the costs and benefits of developing and providing the information, are the same as considerations about cost allocations in other circumstances.

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Appendix E

Illustrations of Applying the Criteria of Purpose, Audience, and Content to Determine Whether a Program or Management and General Activity Has Been Conducted

Illustration 1

Facts

E.1. Entity A's mission is to prevent drug abuse. Entity A's annual report states that one of its objectives in fulfilling that mission is to assist parents in preventing their children from abusing drugs.

E.2. Entity A mails informational materials to the parents of all junior high school students explaining the prevalence and dangers of drug abuse. The materials encourage parents to counsel children about the dangers of drug abuse and inform them about how to detect drug abuse. The mailing includes a request for contributions. Entity A conducts other activities informing the public about the dangers of drug abuse and encouraging parents to counsel their children about drug abuse that do not include requests for contributions and that are conducted in different media. Entity A's executive director is involved in the development of the informational materials as well as the request for contributions. The executive director's annual compensation includes a significant bonus if total annual contributions exceed a predetermined amount.

Conclusion

E.3. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.4. The activity calls for specific action by the recipient (encouraging parents to counsel children about the dangers of drug abuse and informing them about how to detect drug abuse) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. Neither of the factors in paragraph .10*a* or .10*b* is determinative of whether the purpose criterion is met. (Although Entity A's executive director's annual compensation varies based on annual contributions, the executive director's compensation does not vary based on contributions raised for this discrete joint activity.) Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because (*a*) the program component of this activity calls for specific action by the recipient (encouraging parents to counsel children about the dangers of drug abuse) that will help accomplish the entity's mission, and it otherwise conducts the program activity in this illustration without a request for contributions, and (*b*) performing such programs helps accomplish Entity A's mission. (Note that had Entity A conducted the activity using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions, the purpose criterion would have been met under paragraph .10*b*.)

E.5. The audience criterion is met because the audience (parents of junior high school students) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

E.6. The content criterion is met because the activity calls for specific action by the recipient (encouraging parents to counsel children about the dangers of drug abuse and informing them about how to detect drug abuse) that will help accomplish the entity's mission (assisting parents in preventing their children from abusing drugs), and it explains the need for and benefits of the action (the prevalence and dangers of drug abuse).

Illustration 2

Facts

E.7. Entity B's mission is to reduce the incidence of illness from ABC disease, which afflicts a broad segment of the population. One of Entity B's objectives in fulfilling that mission is to inform the public about the effects and early warning signs of the disease and specific action that should be taken to prevent the disease.

E.8. Entity B maintains a list of its prior donors and sends them donor renewal mailings. The mailings include messages about the effects and early warning signs of the disease and specific action that should be taken to prevent it. That information is also sent to a similar-sized audience but without the request for contributions. Also, Entity B believes that recent donors are more likely to contribute than nondonors or donors who have not contributed recently. Prior donors are deleted from the mailing list if they have not contributed to Entity B recently, and new donors are added to the list. There is no evidence of a correlation between recent contributions and participation in the program component of the activity. Also, the prior donors' need to use or reasonable potential for use of the messages about the effects and early warning signs of the disease and specific action that should be taken to prevent it is an insignificant factor in their selection.

Conclusion

E.9. The purpose and content criteria are met. The audience criterion is not met.[11] All costs, including those that might otherwise be considered program or management and general costs if they had been incurred in a different activity, should be charged to fund raising.

E.10. The activity calls for specific action by the recipient (action that should be taken to prevent ABC disease) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. The purpose criterion is met because (*a*) the program component of the activity calls for specific action by the recipient that will help accomplish the entity's mission (to reduce the incidence of illness from the disease), and (*b*) the program is also conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (a similar mailing is done without the request for contributions, to a similar-sized audience).

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[11] Paragraph .07 of this SOP provides that all costs of joint activities, except for costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should be charged to fund raising if any of the criteria of purpose, audience, or content are not met. Accordingly, if one or more criteria are not met, the other criteria need not be considered. However, the illustrations in this Appendix provide conclusions about whether each of the criteria would be met in circumstances in which one or more criteria are not met in order to provide further guidance.

E.11. The audience criterion is not met. The rebuttable presumption that the audience criterion is not met because the audience includes prior donors is not overcome in this illustration. Although the audience has a need to use or reasonable potential for use of the program component, that was an insignificant factor in its selection.

E.12. The content criterion is met because the activity calls for specific action by the recipient (actions to prevent ABC disease) that will help accomplish the entity's mission (to reduce the incidence of ABC disease), and it explains the need for and benefits of the action (to prevent ABC disease).

Illustration 3

Facts

E.13. Entity C's mission is to reduce the incidence of illness from ABC disease, which afflicts a broad segment of the population. One of Entity C's objectives in fulfilling that mission is to increase governmental funding for research about ABC disease.

E.14. Entity C maintains a list of its prior donors and its employees call them on the telephone reminding them of the effects of ABC disease, asking for contributions, and encouraging them to contact their elected officials to urge increased governmental funding for research about ABC disease. The callers are educated about ABC, do not otherwise perform fund-raising functions, and are not compensated or evaluated based on contributions raised. Entity C's research indicates that recent donors are likely to contact their elected officials about such funding while nonrecent donors are not. Prior donors are deleted from the calling list if they have not contributed to Entity C recently, and new donors are added to the list.

Conclusion

E.15. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.16. The activity calls for specific action by the recipient (contacting elected officials concerning funding for research about ABC disease) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. Neither of the factors in paragraph .10*a* or .10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because (*a*) the qualifications and duties of the personnel performing the activity indicate that it is a program activity (the callers are educated about ABC and do not otherwise perform fund-raising functions), (*b*) the method of compensation for performing the activity does not indicate that it is a fund-raising activity (the employees are not compensated or evaluated based on contributions raised), and (*c*) performing such programs helps accomplish Entity C's mission.

E.17. The audience criterion is met because the audience (recent donors) is selected based on its ability to assist Entity C in meeting the goals of the program component of the activity (recent donors are likely to contact their elected officials about such funding while nonrecent donors are not).

E.18. The content criterion is met because the activity calls for specific action by the recipient (contacting elected officials concerning funding for research about ABC disease) that will help accomplish the entity's mission (to reduce the incidence of ABC disease), and it explains the need for and benefits of the action (to prevent ABC disease).

Illustration 4

Facts

E.19. Entity D's mission is to improve the quality of life for senior citizens. One of Entity D's objectives included in that mission is to increase the physical activity of senior citizens. One of Entity D's programs to attain that objective is to send representatives to speak to groups about the importance of exercise and to conduct exercise classes.

E.20. Entity D mails a brochure on the importance of exercise that encourages exercise in later years to residents over the age of sixty-five in three zip code areas. The last two pages of the four-page brochure include a perforated contribution remittance form on which Entity D explains its program and makes an appeal for contributions. The content of the first two pages of the brochure is primarily educational; it explains how seniors can undertake a self-supervised exercise program and encourages them to undertake such a program. In addition, Entity D includes a second brochure on various exercise techniques that can be used by those undertaking an exercise program.

E.21. The brochures are distributed to educate people in this age group about the importance of exercising, to help them exercise properly, and to raise contributions for Entity D. These objectives are documented in a letter to the public relations firm that developed the brochures. The audience is selected based on age, without regard to ability to contribute. Entity D believes that most of the recipients would benefit from the information about exercise.

Conclusion

E.22. The purpose, audience, and content criteria are met, and the joint costs should be allocated. (Note that the costs of the second brochure should be charged to program because all the costs of the brochure are identifiable with the program function.)

E.23. The activity calls for specific action by the recipient (exercising) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. Neither of the factors in paragraph .10*a* or .10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because (*a*) performing such programs helps accomplish Entity D's mission, and (*b*) the objectives of the program are documented in a letter to the public relations firm that developed the brochure.

E.24. The audience criterion is met because the audience (residents over sixty-five in certain zip codes) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

E.25. The content criterion is met because the activity calls for specific action by the recipient (exercising) that will help accomplish the entity's mission (increasing the physical activity of senior citizens), and the need for and benefits of the action are clearly evident (explains the importance of exercising).

Illustration 5

Facts

E.26. The facts are the same as those in Illustration 4, except that Entity E employs a fund-raising consultant to develop the first brochure and pays that consultant 30 percent of contributions raised.

Conclusion

E.27. The content and audience criteria are met. The purpose criterion is not met, however, because a majority of compensation or fees for the fund-raising consultant varies based on contributions raised for this discrete joint activity (the fund-raising consultant is paid 30 percent of contributions raised). All costs should be charged to fund raising, including the costs of the second brochure and any other costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity.

Illustration 6

Facts

E.28. Entity F's mission is to protect the environment. One of Entity F's objectives included in that mission is to take action that will increase the portion of waste recycled by the public.

E.29. Entity F conducts a door-to-door canvass of a community that recycles a low portion of its waste. The purpose of the activity is to help increase recycling by educating the community about environmental problems created by not recycling, and to raise contributions. Based on the information communicated by the canvassers, the need for and benefits of the action are clearly evident. The ability or likelihood of the residents to contribute is not a basis for communities selected, and all neighborhoods in the geographic area are covered if their recycling falls below a predetermined rate. The canvassers are selected from individuals who are well-informed about the organization's environmental concerns and programs and who previously participated as volunteers in program activities such as answering environmental questions directed to the organization and developing program activities designed to influence legislators to take actions addressing those concerns. The canvassers have not previously participated in fund-raising activities.

Conclusion

E.30. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.31. The activity calls for specific action by the recipient (implicitly—to help increase recycling) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. Neither of the factors in paragraph .10*a* or .10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because (*a*) the qualifications and duties of the personnel performing the activity indicate that it is a program activity (the canvassers are selected from individuals who are well-informed about the organization's environmental concerns and programs and who previously participated as volunteers in program activities such as answering environmental questions directed to the organization and developing program activities designed to influence legislators to take actions addressing those concerns), and (*b*) performing such programs helps accomplish Entity F's mission (to protect the environment).

E.32. The audience criterion is met because the audience (neighborhoods whose recycling falls below a predetermined rate) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

E.33. The content criterion is met because the activity calls for specific action by the recipient (implicitly—to help increase recycling) that will help accomplish the entity's mission (to protect the environment), and the need for and benefits of the action are clearly evident (increased recycling will help alleviate environmental problems).

Illustration 7

Facts

E.34. Entity G's mission is to provide summer camps for economically disadvantaged youths. Educating the families of ineligible youths about the camps is not one of the program objectives included in that mission.

E.35. Entity G conducts a door-to-door solicitation campaign for its camp programs. In the campaign, volunteers with canisters visit homes in middle-class neighborhoods to collect contributions. Entity G believes that people in those neighborhoods would not need the camp's programs but may contribute. The volunteers explain the camp's programs, including why the disadvantaged children benefit from the program, and distribute leaflets to the residents regardless of whether they contribute to the camp. The leaflets describe the camp, its activities, who can attend, and the benefits to attendees. Requests for contributions are not included in the leaflets.

Conclusion

E.36. The purpose, audience, and content criteria are not met. All costs should be charged to fund raising.

E.37. The activity does not include a call for specific action because it only educates the audience about causes (describing the camp, its activities, who can attend, and the benefits to attendees). Therefore, the purpose criterion is not met.

E.38. The audience criterion is not met, because the audience is selected based on its ability or likelihood to contribute, rather than based on (*a*) its need to use or reasonable potential for use of the action called for by the program component, or (*b*) its ability to take action to assist the entity in meeting the goals of the program component of the activity. (Entity G believes that people in those neighborhoods would not need the camp's programs but may contribute.)

E.39. The content criterion is not met because the activity does not call for specific action by the recipient. (The content educates the audience about causes that the program is designed to address without calling for specific action.)

Illustration 8

Facts

E.40. Entity H's mission is to educate the public about lifesaving techniques in order to increase the number of lives saved. One of Entity H's objectives in fulfilling that mission, as stated in the minutes of the board's meetings, is to produce and show television broadcasts including information about lifesaving techniques.

E.41. Entity H conducts an annual national telethon to raise contributions and to reach the American public with lifesaving educational messages, such as summary instructions concerning dealing with certain life-threatening situations. Based on the information communicated by the messages, the need for and benefits of the action are clearly evident. The broadcast includes segments describing Entity H's services. Entity H broadcasts the telethon to the entire country, not merely to areas selected on the basis of giving potential or prior fund raising results. Also, Entity H uses national television broadcasts devoted entirely to lifesaving educational messages to conduct program activities without fund raising.

Conclusion

E.42. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.43. The activity calls for specific action by the recipient (implicitly—to save lives) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. The purpose criterion is met because (*a*) the program component of the activity calls for specific action by the recipient that will help accomplish Entity H's mission (to save lives by educating the public), and (*b*) a similar program activity is conducted without the fund raising using the same medium and on a scale that is similar to or greater than the scale on which it is conducted with the appeal (Entity H uses national television broadcasts devoted entirely to lifesaving educational messages to conduct program activities without fund raising).

E.44. The audience criterion is met because the audience (a broad segment of the population) is selected based on its need to use or reasonable potential for use of the action called for by the program activity.

E.45. The content criterion is met because the activity calls for specific action by the recipient (implicitly—to save lives) that will help accomplish the entity's mission (to save lives by educating the public), and the need for and benefits of the action are clearly evident (saving lives is desirable).

Illustration 9

Facts

E.46. Entity I's mission is to provide food, clothing, and medical care to children in developing countries.

E.47. Entity I conducts television broadcasts in the United States that describe its programs, show the needy children, and end with appeals for contributions. Entity I's operating policies and internal management memoranda state that these programs are designed to educate the public about the needs of children in developing countries and to raise contributions. The employees producing the programs are trained in audiovisual production and are familiar with Entity I's programs. Also, the executive producer is paid $25,000 for this activity, with a $5,000 bonus if the activity raises over $1,000,000.

Conclusion

E.48. The purpose, audience, and content criteria are not met. All costs should be charged to fund raising.

E.49. The activity does not include a call for specific action because it only educates the audience about causes (describing its programs and showing the needy children). Therefore, the purpose criterion is not met. (Also, note that if the factor in paragraph .10*a* were considered, it would not be determinative of whether the purpose criterion is met. Although the executive producer will be paid $5,000 if the activity raises over $1,000,000, that amount would not be a majority of the executive producer's total compensation for this activity, because $5,000 would not be a majority of the executive producer's total compensation of $30,000 for this activity. Also, note that if other evidence, such as the indicators in paragraph .11, were considered, the purpose criterion would not be met based on the other evidence. Although the qualifications and duties of the personnel performing the activity indicate that the employees producing the program are familiar with Entity I's programs, the facts that some, but less than a majority, of the executive producer's compensation varies based on contributions raised, and that the operating policies and internal management memoranda state that these programs are designed to educate the public about the needs of children in developing countries [with no call for specific action by recipients] and to raise contributions, indicate that the purpose is fund raising.)

E.50. The audience criterion is not met because the audience is selected based on its ability or likelihood to contribute, rather than based on (*a*) its need to use or reasonable potential for use of the action called for by the program component, or (*b*) its ability to take action to assist the entity in meeting the goals of the program component of the activity. (The audience is a broad segment of the population of a country that is not in need of or has no reasonable potential for use of the program activity.)

E.51. The content criterion is not met because the activity does not call for specific action by the recipient that will help accomplish the entity's mission. (The content educates the audience about the causes without calling for specific action.)

Illustration 10

Facts

E.52. Entity J is a university that distributes its annual report, which includes reports on mission accomplishments, to those who have made significant contributions over the previous year, its board of trustees, and its employees. The annual report is primarily prepared by management and general personnel, such as the accounting department and executive staff. The activity is coordinated by the public relations department. Internal management memoranda indicate that the purpose of the annual report is to report on how management discharged its stewardship responsibilities, including the university's overall performance, goals, financial position, cash flows, and results of operations. Included in the package containing the annual report are requests for contributions and donor reply cards.

Conclusion

E.53. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.54. The activity has elements of management and general functions. Therefore, no call for specific action is required. Neither of the factors in paragraph .10*a* or .10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because (*a*) the employees performing the activity are not members of the fund-raising department and perform other non-fund-raising activities and (*b*) internal management memoranda indicate that the purpose of the annual report is to fulfill one of the university's management and general responsibilities.

E.55. The audience criterion is met because the audience is selected based on its reasonable potential for use of the management and general component. Although the activity is directed primarily at those who have previously made significant contributions, the audience was selected based on its presumed interest in Entity J's annual report (prior donors who have made significant contributions are likely to have an interest in matters discussed in the annual report).

E.56. The content criterion is met because the activity (distributing annual reports) fulfills one of the entity's management and general responsibilities (reporting concerning management's fulfillment of its stewardship function).

Illustration 11

Facts

E.57. Entity K is an NPO. In accordance with internal management memoranda documenting its policies requiring it to comply with Internal Revenue Service (IRS) regulations, it mails prior donors who have made quid pro quo payments in excess of $75 documentation required by the IRS. The documentation is included on a perforated piece of paper. The information above the perforation line pertains to the documentation required by the IRS. The information below the perforation line includes a request for contributions and may be used as a donor reply card.

Conclusion

E.58. The purpose, audience, and content criteria are met, and the joint costs should be allocated. (Note that the costs of the information below the perforation line are identifiable with fund raising and therefore should be charged to fund raising.)

E.59. The activity has elements of management and general functions. Therefore, no call for specific action is required. Neither of the factors in paragraph .10*a* or .10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because internal management memoranda indicate that the purpose of the activity is to fulfill one of Entity K's management and general responsibilities.

E.60. The audience criterion is met because the entity is required to direct the management and general component of the activity to the particular audience. Although the activity is directed at those who have previously contributed, the audience was selected based on its need for the documentation.

E.61. The content criterion is met because the activity (sending documentation required by the IRS) fulfills one of the entity's management and general responsibilities (complying with IRS regulations).

Illustration 12

Facts

E.62. Entity L is an animal rights organization. It mails a package of material to individuals included in lists rented from various environmental and other organizations that support causes that Entity L believes are congruent with its own. In addition to donor response cards and return envelopes, the package includes (*a*) materials urging recipients to contact their legislators and urge the legislators to support legislation to protect those rights, and (*b*) postcards addressed to legislators urging support for legislation restricting the use of animal testing for cosmetic products. The mail campaign is part of an overall strategy that includes magazine advertisements and the distribution of similar materials at various community events, some of which are undertaken without fund-raising appeals. The advertising and community events reach audiences similar in size and demographics to the audience reached by the mailing.

Conclusion

E.63. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.64. The activity calls for specific action by the recipient (mailing postcards to legislators urging support for legislation restricting the use of animal testing for cosmetic products) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. Neither of the factors in paragraph .10*a* or .10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because (*a*) the program component of this activity calls for specific action by the recipient that will help accomplish the entity's mission, and it otherwise conducts the program activity in this illustration without a request for contributions, and (*b*) performing such programs helps accomplish Entity L's mission.

E.65. The audience criterion is met because the audience (individuals included in lists rented from various environmental and other organizations that support causes that Entity L believes are congruent with its own) is selected based on its ability to take action to assist the entity in meeting the goals of the program component of the activity.

E.66. The content criterion is met because the activity calls for specific action by the recipient (mailing postcards to legislators urging support for legislation restricting the use of animal testing for cosmetic products) that will help accomplish the entity's mission (to protect animal rights), and the need for and benefits of the action are clearly evident (to protect animal rights).

Illustration 13

Facts

E.67. Entity M is a performing arts organization whose mission is to make the arts available to residents in its area. Entity M charges a fee for attending performances and sends advertisements, including subscription forms, for the performances to residents in its area. These advertisements include a return envelope with a request for contributions. Entity M evaluates the effectiveness of the advertising based on the number of subscriptions sold as well as contributions received. In performing that evaluation, Entity M places more weight on the number of subscriptions sold than on the contributions received. Also, Entity M advertises the performances on local television and radio without a request for contributions but on a smaller scale than the mail advertising.

Conclusion

E.68. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.69. The activity calls for specific action by the recipient (attending the performances) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. Neither of the factors in paragraph .10*a* or .10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because (*a*) the entity measures program results and accomplishments of the joint activity and in evaluating the effectiveness of the activity, the entity places significantly greater weight on the activity's effectiveness in accomplishing program goals than on the activity's effectiveness in raising contributions (Entity M evaluates the effectiveness of the advertising based on the number of subscriptions sold as well as contributions received and places more weight on the number of subscriptions sold than on the contributions received), (*b*) it otherwise conducts the program activity without a request for contributions, and (*c*) performing such programs helps accomplish Entity M's mission (to make the arts available to residents in its area).

E.70. The audience criterion is met because the audience (a broad segment of the population in Entity M's area) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

E.71. The content criterion is met because the activity calls for specific action by the recipient (attending the performances) that will help accomplish the entity's mission (making the arts available to area residents), and the need for and benefits of the action are clearly evident (attending the performance is a positive cultural experience). (Note that the purchase of subscriptions is an exchange transaction and, therefore, is not a contribution.)

Illustration 14

Facts

E.72. Entity N is a university whose mission is to educate the public (students) in various academic pursuits. Entity N's political science department holds a special lecture series in which prominent world leaders speak about current events. The speakers command relatively high fees and, in order to cover costs and make a modest profit, the university sets a relatively expensive fee to attend. However, the tickets are priced at the fair value of the lecture and no portion of the ticket purchase price is a contribution. Entity N advertises the lectures by sending invitations to prior attendees and to prior donors who have contributed significant amounts, and by placing advertisements in local newspapers read by the general public. At some of the lectures, including the lecture being considered in this illustration, deans and other faculty members of Entity N solicit significant contributions from attendees. Other lectures in the series are conducted on a scale similar to the scale of the lecture in this illustration without requesting contributions. Entity N's records indicate that historically 75 percent of the attendees have attended prior lectures. Of the 75 percent who have attended prior lectures, 15 percent have made prior contributions to Entity N. Of the 15 percent who have made prior contributions to Entity N, 5 percent have made contributions in response to solicitations made at the events. (Therefore, one-half of one percent of attendees make contributions in response to solicitations made at the events. However, those contributions are significant.) Overall, the audience's ability or likelihood to contribute is an insignificant factor in its selection. Entity N evaluates the effectiveness of the activity based on the number of tickets sold, as well as contributions received. In performing that evaluation, Entity N places more weight on the number of tickets sold than on the contributions received.

Conclusion

E.73. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.74. The activity calls for specific action by the recipient (attending the lecture) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. The purpose criterion is met because (*a*) the program component of the activity calls for specific action by the recipient that will help accomplish the entity's mission (educating the public [students] in various academic pursuits), and (*b*) the program is also conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (other lectures in the series are conducted on a scale similar to the scale of the lecture in this illustration without requesting contributions).

E.75. The audience criterion is met. The rebuttable presumption that the audience criterion is not met because the audience includes prior donors is overcome in this illustration because the audience (those who have shown prior interest in the lecture series, prior donors, a broad segment of the population in Entity N's area, and those attending the lecture) is also selected for its reasonable potential for use of the program component (attending the lecture). Although the audience may make significant contributions, that was an insignificant factor in its selection.

E.76. The content criterion is met because the activity calls for specific action by the recipient (attending the lecture) that will help accomplish the entity's mission (educating the public [students] in various academic pursuits), and the need for and benefits of the action are clearly evident (attending the lecture is a positive educational experience). (Note that the purchase of the tickets is an exchange transaction and, therefore, is not a contribution. As discussed in paragraph .07 of this SOP, costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event, should not be reported as fund raising.[12])

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[12] Paragraphs 13.21-13.26 of the Audit and Accounting Guide *Not-for-Profit Organizations* provide guidance concerning reporting special events. [Footnote revised, June 2004, to reflect conforming changes necessary due to conforming changes made to the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*.]

Illustration 15

Facts

E.77. Entity O is a university whose mission is to educate the public (students) in various academic pursuits. Entity O's political science department holds a special lecture series in which prominent world leaders speak about current events. Admission is priced at $250, which is above the $50 fair value of the lecture and, therefore, $200 of the admission price is a contribution. Therefore, the audience's likelihood to contribute to the entity is a significant factor in its selection. Entity O advertises the lectures by sending invitations to prior attendees and to prior donors who have contributed significant amounts, and by placing advertisements in local newspapers read by the general public. Entity O presents similar lectures that are priced at the fair value of those lectures.

Conclusion

E.78. The purpose and content criteria are met. The audience criterion is not met. All costs, including those that might otherwise be considered program or management and general costs if they had been incurred in a different activity, except for the costs of the direct donor benefit (the lecture), should be charged to fund raising.

E.79. The activity calls for specific action by the recipient (attending the lecture) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. The purpose criterion is met because (*a*) the program component of the activity calls for specific action by the recipient that will help accomplish the entity's mission (educating the public [students] in various academic pursuits), and (*b*) the program is also conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (other lectures in the series are conducted on a scale similar to the scale of the lecture in this illustration without including a contribution in the admission price.)

E.80. The audience criterion is not met. The rebuttable presumption that the audience criterion is not met because the audience is selected based on its likelihood to contribute to the entity is not overcome in this illustration. The fact that the $250 admission price includes a $200 contribution leads to the conclusion that the audience's ability or likelihood to contribute is an overwhelmingly significant factor in its selection, whereas there is no evidence that the extent to which the audience is selected for its need to use or reasonable potential for use of the action called for by the program component (attending the lecture) is overwhelmingly significant.

E.81. The content criterion is met because the activity calls for specific action by the recipient (attending the lecture) that will help accomplish the entity's mission (educating the public [students] in various academic pursuits), and the need for and benefits of the action are clearly evident (attending the lecture is a positive educational experience). (Note that the purchase of the tickets is an exchange transaction and, therefore, is not a contribution. As discussed in paragraph .07 of this SOP, costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event, should not be reported as fund raising.[13])

Illustration 16

Facts

E.82. Entity P's mission is to reduce the incidence of illness from ABC disease, which primarily afflicts people over sixty-five years of age. One of Entity P's objectives in fulfilling that mission is to have all persons over sixty-five screened for ABC disease.

E.83. Entity P rents space at events attended primarily by people over sixty-five years of age and conducts free screening for ABC disease. Entity P's employees, who are educated about ABC disease and screening procedures and do not otherwise perform fund-raising functions, educate interested parties about the effects of ABC disease and the ease and benefits of screening for it. Entity P also solicits contributions at the events. The effectiveness of the activity is evaluated primarily based on how many screening tests are performed, and only minimally based on contributions raised. The employees are not compensated or evaluated based on contributions raised.

Conclusion

E.84. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.85. The activity calls for specific action by the recipient (being screened for ABC disease) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. Neither of the factors in paragraph .10*a* or .10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because (*a*) a process exists to evaluate measured program results and accomplishments and in evaluating the effectiveness of the joint activity, the entity places significantly greater weight on the activity's effectiveness in accomplishing program goals than on the activity's effectiveness in raising contributions (Entity P evaluates the effectiveness of the activity based on the number of screening tests conducted as well as contributions received and places more weight on the number of tests conducted than on the contributions received); (*b*) the qualifications and duties of the personnel performing the activity indicate that it is a program activity (the employees are educated about ABC disease and the testing procedures and do not otherwise perform fund-raising functions); (*c*) the method of compensation for performing the activity does not indicate that it is a fund-raising activity (the employees are not compensated or evaluated based on contributions raised); and (*d*) performing such programs helps accomplish Entity P's mission (to prevent ABC disease).

E.86. The audience criterion is met because the audience (people over sixty-five years of age) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

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[13] Paragraphs 13.21-13.26 of the Audit and Accounting Guide *Not-for-Profit Organizations* provide guidance concerning reporting special events. [Footnote revised, June 2004, to reflect conforming changes necessary due to conforming changes made to the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*.]

E.87. The content criterion is met because the activity calls for specific action by the recipient (being screened for ABC disease) that will help accomplish the entity's mission (to reduce the incidence of ABC disease), and it explains the need for and benefits of the action (to prevent ABC disease).

Illustration 17

Facts

E.88. Entity Q's mission is to provide cultural and educational television programming to residents in its area. Entity Q owns a public television station and holds a membership drive in which it solicits new members. The drive is conducted by station employees and consists of solicitations that are shown during long breaks between the station's regularly scheduled programs. Entity Q's internal management memoranda state that these drives are designed to raise contributions. Entity Q evaluates the effectiveness of the activity based on the amount of contributions received. Entity Q shows the programs on a similar scale, without the request for contributions. The audience is members of the general public who watch the programs shown during the drive. Station member benefits are given to those who contribute and consist of tokens of appreciation with a nominal value.

Conclusion

E.89. The purpose, audience, and content criteria are met, and the joint costs should be allocated. (Note that there would be few, if any, joint costs. Costs associated with the fund-raising activities, such as costs of airtime, would be separately identifiable from costs of the program activities, such as licensing costs for a particular television program. Also, note that because no significant benefits or duties are associated with membership, member dues are contributions. Therefore, the substance of the membership-development activities is, in fact, fund raising.)

E.90. The activity calls for specific action by the recipient (watching the television program) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. The purpose criterion is met because (*a*) the program component of the activity calls for specific action by the recipient that will help accomplish the entity's mission, and (*b*) the program is also conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (Entity Q shows the television programs on a similar scale, without the request for contributions).

E.91. The audience criterion is met. The rebuttable presumption that the audience criterion is not met because the audience is selected based on its likelihood to contribute is overcome in this illustration because the audience (members of the general public who watch the television programs shown during the drive) is also selected for its reasonable potential for use of the program component (watching the television programs). Although the audience may make contributions, that was an insignificant factor in its selection.

E.92. The content criterion is met because the activity calls for specific action by the recipient (watching the television programs) that will help accomplish the entity's mission (providing cultural and educational television programming to residents in its area), and the need for and benefits of the action are clearly evident (watching the programs is a positive cultural and educational experience).

.26

Appendix F

Illustrations of Allocation Methods

F.1. Some commonly used cost allocation methods follow.

Physical Units Method

F.2. Joint costs are allocated to materials and activities in proportion to the number of units of output that can be attributed to each of the materials and activities. Examples of units of output are lines, square inches, and physical content measures. This method assumes that the benefits received by the fund-raising, program, or management and general component of the materials or activity from the joint costs incurred are directly proportional to the lines, square inches, or other physical output measures attributed to each component of the activity. This method may result in an unreasonable allocation of joint costs if the units of output, for example, line counts, do not reflect the degree to which costs are incurred for the joint activity. Use of the physical units method may also result in an unreasonable allocation if the physical units cannot be clearly ascribed to fund raising, program, or management and general. For example, direct mail and telephone solicitations sometimes include content that is not identifiable with fund raising, program, or management and general; or the physical units of such content are inseparable.

Illustration

F.3. Assume a direct mail campaign is used to conduct programs of the entity and to solicit contributions to support the entity and its programs. Further, assume that the appeal meets the criteria for allocation of joint costs to more than one function.

F.4. The letter and reply card include a total of one hundred lines. Forty-five lines pertain to program because they include a call for action by the recipient that will help accomplish the entity's mission, while fifty-five lines pertain to the fund-raising appeal. Accordingly, 45 percent of the costs are allocated to program and 55 percent to fund-raising.

Relative Direct Cost Method

F.5. Joint costs are allocated to each of the components on the basis of their respective direct costs. Direct costs are those costs that are incurred in connection with the multipurpose materials or activity and that are specifically identifiable with a function (program, fund raising, or management and general). This method may result in an unreasonable allocation of joint costs if the joint costs of the materials and activity are not incurred in approximately the same proportion and for the same reasons as the direct costs of the materials and activity. For example, if a relatively costly booklet informing the reader about the entity's mission (including a call for action by the recipient that will help accomplish the entity's mission) is included with a relatively inexpensive fund-raising letter, the allocation of joint costs based on the cost of these pieces may be unreasonable, particularly if the booklet and letter weigh approximately the same and therefore contribute equally to the postage costs.

Illustration

F.6. The costs of a direct mail campaign that can be specifically identified with program services are the costs of separate program materials and a postcard which calls for specific action by the recipient that will help accomplish the entity's mission. They total $20,000. The direct costs of the fund-raising component of the direct mail campaign consist of the costs to develop and produce the fund-raising letter. They total $80,000. Joint costs associated with the direct mail campaign total $40,000 and would be allocated as follows under the relative direct cost method:

Program $20,000/$100,000 x $40,000 = $8,000

Fund raising $80,000/$100,000 x $40,000 = $32,000

Stand-Alone Joint-Cost-Allocation Method

F.7. Joint costs are allocated to each component of the activity based on a ratio that uses estimates of costs of items included in joint costs that would have been incurred had the components been conducted independently. The numerator of the ratio is the cost (of items included in joint costs) of conducting a single component independently; the denominator is the cost (of items included in joint costs) of conducting all components independently. This method assumes that efforts for each component in the stand-alone situation are proportionate to the efforts actually undertaken in the joint cost situation. This method may result in an unreasonable allocation because it ignores the effect of each function, which is performed jointly with other functions, on other such functions. For example, the programmatic impact of a direct mail campaign or a telemarketing phone message may be significantly lessened when performed in conjunction with a fund-raising appeal.

Illustration

F.8. Assume that the joint costs associated with a direct mail campaign including both program and fund-raising components are the costs of stationery, postage, and envelopes at a total of $100,000. The costs of stationery, postage, and envelopes to produce and distribute each component separately would have been $90,000 for the program component and $70,000 for the fund-raising component. Under the stand-alone joint-cost-allocation method, the $100,000 in joint costs would be allocated as follows: $90,000/$160,000 x $100,000 = $56,250 to program services and $70,000/$160,000 x $100,000 = $43,750 to fund raising.

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Appendix G

Illustrations of Disclosures

G.1. The disclosures discussed in paragraphs .18 and .19 are illustrated below. Alternative 1 reports the required and encouraged information in narrative format. Alternative 2 reports that information in tabular format, as well as information concerning joint costs incurred for each kind of activity by functional classification, which is neither required nor encouraged, but which is not prohibited.

Alternative 1

Note X. Allocation of Joint Costs

In 19XX, the organization conducted activities that included requests for contributions, as well as program and management and general components. Those activities included direct mail campaigns, special events, and a telethon. The costs of conducting those activities included a total of $310,000 of joint costs, which are not specifically attributable to particular components of the activities (joint costs). [*Note to reader: The following sentence is encouraged but not required.*] Joint costs for each kind of activity were $50,000, $150,000, and $110,000 respectively. These joint costs were allocated as follows:

Fund raising	$180,000
Program A	80,000
Program B	40,000
Management and general	10,000
Total	$310,000

Alternative 2

Note X. Allocation of Joint Costs

In 19XX, the organization conducted activities that included appeals for contributions and incurred joint costs of $310,000. These activities included direct mail campaigns, special events, and a telethon. Joint costs were allocated as follows:

	Direct Mail	Special Events	Telethon	Total
Fund raising	$40,000	$50,000	$90,000	$180,000
Program A	10,000	65,000	5,000	80,000
Program B		25,000	15,000	40,000
Management and general		10,000		10,000
Total	$50,000	$150,000	$110,000	$310,000

[***Note to reader:*** *Shading is used to highlight information that is neither required nor encouraged, but which is not prohibited. However, entities may prefer to disclose it. Disclosing the total joint costs for each kind of activity ($50,000, $150,000, and $110,000) is encouraged but not required.*]

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Appendix H

Contrast of Guidance in This SOP With the Guidance in SOP 87-2[14,**]

This SOP	*SOP 87-2*
Applies to all entities that solicit contributions, including state and local governments.	Applied to entities that follow the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations* or SOP 78-10. (SOP 87-2 was not applicable to entities that are within the scope of Governmental Accounting Standards Board Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*.)
Covers *all* costs of joint activities. (Costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity, except for costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event [for example, a meal], should be charged to fund raising unless the criteria in the SOP are met.)	Covers only joint costs of joint activities.
Criteria of purpose, audience, and content should all be met in order to charge costs of the activity to program or management and general.	Unclear concerning whether all criteria should be met in order to charge costs of the activity to program or management and general.

[14] In August 1996, the AICPA issued the Audit and Accounting Guide *Not-for-Profit Organizations*, which superseded SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, because the guidance in SOP 87-2 is incorporated into paragraphs 13.36 to 13.45 of the Guide. Also, *Not-for-Profit Organizations* superseded the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations* and SOP 78-10. *Not-for-Profit Organizations* applies to all nongovernmental not-for-profit organizations other than those required to follow the Audit and Accounting Guide *Health Care Organizations*. Therefore, incorporating the guidance in SOP 87-2 into *Not-for-Profit Organizations* broadened the scope of the guidance previously included in SOP 87-2 to all not-for-profit organizations other than those required to follow *Health Care Organizations*. The discussion in this SOP of SOP 87-2 refers to both SOP 87-2 and the guidance included in paragraphs 13.36 to 13.45 of *Not-for-Profit Organizations*, except that the guidance in *Not-for-Profit Organizations* applies to all not-for-profit organizations other than those required to follow *Health Care Organizations*.

[**] See footnotes ‡ and | | in paragraphs D.3 and D.4, respectively. [Footnote revised, June 2004, to reflect conforming changes necessary due to the issuance of GASB Statements No. 34 and No. 35.]

This SOP	*SOP 87-2*
Neither prescribes nor prohibits any allocation methods. Includes a discussion to help users determine whether an allocation is reasonable, and provides some illustrations.	Neither prescribes nor prohibits any allocation methods. No illustrations are provided.
Requires note disclosures about the types of activities for which joint costs have been incurred, amounts allocated during the period, and amounts allocated to each functional expense or expenditure category.	Requires less extensive note disclosures: total amount allocated during the period and amounts allocated to each functional expense category.

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Appendix I

Effects on Other Guidance

I.1. For nongovernmental organizations, this Statement of Position (SOP) amends the AICPA Audit and Accounting Guide *Health Care Organizations* and paragraphs 13.35 to 13.44 of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*. [Revised, June 2004, to reflect conforming changes necessary due to conforming changes made to the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*.]

I.2. Also, this SOP amends the AICPA Audit and Accounting Guide *Not-for-Profit Organizations* to clarify that costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should not be reported as fund-raising. In particular, paragraphs 13.21, 13.23, and 13.24 of *Not-for-Profit Organizations* are amended as follows:

> **13.21** Some organizations conduct joint activities [fn 9] that are special events, including special social and educational events (such as symposia, dinners, dances, and theater parties) in which the attendee receives a direct benefit (for example, a meal or theater ticket). FASB Statement No. 117 requires the reporting of the gross amounts of revenues and expenses from special events and other fund-raising activities that are ongoing major or central activities, but permits (but does not require) reporting net amounts if the receipts and related costs result from special events that are peripheral or incidental activities.
>
> **13.23** For example, assume that an organization has a special event that is an ongoing and major activity with a ticket price of $100. Assume that the activity does not meet the audience criterion in SOP 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising*, and, therefore, all costs of the activity, other than the direct donor benefits, should be reported as fund raising. The event includes a dinner that costs the organization $25 and that has a fair value of $30. (Chapter 5, "Contributions Received and Agency Transactions," of this Guide, discusses the appropriate reporting if the meal or other items of value are donated to the organization for resale.) In addition, the organization incurs other direct costs of the event in connection with promoting and conducting the event, including incremental direct costs incurred in transactions with independent third parties and the payroll and payroll-related costs for the activities of employees who are directly associated with, and devote time to, the event. Those other direct costs, which include (*a*) $5 that otherwise might be considered management and general costs if they had been incurred in a different activity, and (*b*) fund-raising costs of $10, are unrelated to the direct benefits to donors and, accordingly, should not be included as costs of benefits to donors. In addition, the organization has the following transactions, which are unrelated to the special event: unrestricted contributions of $200, program expenses of $60, management and general expenses of $20, and fund-raising expenses of $20.
>
> **13.24** Some ways in which the organization could display the results of the special event as part of its statement of activities are illustrated as follows:

Illustration 1

Changes in unrestricted net assets:		
Contributions		$200
Special event revenue	100	
Less: Costs of direct benefits to donors	(25)	
Net revenues from special events		75
Contributions and net revenues from special events		275
Other expenses:		
Program		60
Management and general		20
Fund raising		35
Total other expenses		115
Increase in unrestricted net assets		$160

Illustration 2

Changes in unrestricted net assets:	
Revenues:	
Contributions	$200
Special event revenue	100
Total revenues	300
Expenses:	
Program	60
Costs of direct benefits to donors	25
Management and general	20
Fund raising	35
Total expenses	140
Increase in unrestricted net assets	$160

Illustration 3

Changes in unrestricted net assets:	
Contributions	$270
Dinner sales	30
Less: Costs of direct benefits to donors	(25)
Gross profit on special events	5
Contributions and net revenues from special events	275
Other expenses:	
Program	60
Management and general	20
Fund raising	35
Total other expenses	115
Increase in unrestricted net assets	$160

fn 9 See footnote 1.

[Revised, June 2004, to reflect conforming changes necessary due to conforming changes made to the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*.]

I.3. For governmental entities that have applied the accounting and financial reporting principles in SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations,* or the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations* (modified by all applicable Financial Accounting Standards Board [FASB] pronouncements issued through November 30, 1989, and by most applicable Governmental Accounting Standards Board [GASB] pronouncements) in conformity with GASB Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*, this SOP amends the principles—based on SOP 78-10 and *Audits of Voluntary Health and Welfare Organizations*, as modified—that those entities apply. For governmental entities that have applied the accounting and financial reporting principles in the 1973 AICPA Industry Audit Guide *Audits of Colleges and Universities*, as amended by SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities*, and as modified by applicable FASB pronouncements issued through November 30, 1989, and all applicable GASB pronouncements in conformity with GASB Statement No. 15, *Governmental College and University Accounting and Financial Reporting Models*, this SOP amends the principles—based on *Audits of Colleges and Universities*, as amended and modified—that those entities apply. For other governmental organizations, this SOP amends the Audit and Accounting Guide *Audits of State and Local Governmental Units*.[††]

[††] See footnotes ‡ and | | in paragraphs D.3 and D.4, respectively. Also, the AICPA Audit and Accounting Guide *State and Local Governments* supersedes the 1994 AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* and subsequent editions of that Guide with conforming changes made by the AICPA staff. The AICPA Audit and Accounting Guide *State and Local Governments*, provides guidance on the application of this SOP to state and local governments. [Footnote added, June 2004, to reflect conforming changes necessary due to the issuance of GASB Statements No. 34, No. 35, and the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*.]

.30

Glossary

Activities. Activities are efforts to accomplish specific objectives. Some activities include producing and distributing materials. For example, if an entity undertakes a mass mailing that includes a letter and a pamphlet, producing and distributing the letter and pamphlet are part of the activity. Other activities may include no materials, such as an annual dinner or a radio commercial.

Compensation or fees. Reciprocal transfers of cash or other assets in exchange for services performed.

Contributions. Contributions are unconditional transfers of cash or other assets to an entity or a settlement or cancellation of its liabilities in a voluntary nonreciprocal transfer by another entity acting other than as an owner.

Costs of joint activities. Costs of joint activities are costs incurred for a joint activity. Costs of joint activities may include joint costs and costs other than joint costs. Costs other than joint costs are costs that are identifiable with a particular function, such as fund raising, program, management and general, and cost of sales. For example, some costs incurred for printing, paper, professional fees, and salaries to produce donor cards are not joint costs, although they may be incurred in connection with conducting joint activities.

Fund-raising activities. Fund-raising activities are activities undertaken to induce potential donors to contribute money, securities, services, materials, facilities, other assets, or time. They include publicizing and conducting fund-raising campaigns; maintaining donor mailing lists; conducting special fund-raising events; preparing and distributing fund-raising manuals, instructions, and other materials; and conducting other activities involved with soliciting contributions from individuals, foundations, governments, and others.

Help accomplish the entity's mission. Actions that help accomplish the entity's mission are actions that either benefit the recipient (such as by improving the recipient's physical, mental, emotional, or spiritual health and well-being) or benefit society (by addressing societal problems).

Joint activity. A joint activity is an activity that is part of the fund-raising function and has elements of one or more other functions, such as program, management and general, membership development, or any other functional category used by the entity.

Joint costs. Joint costs are the costs of conducting joint activities that are not identifiable with a particular component of the activity. For example, the cost of postage for a letter that includes both fund-raising and program components is a joint cost. Joint costs may include the costs of salaries, contract labor, consultants, professional fees, paper, printing, postage, event advertising, telephones, airtime, and facility rentals.

Management and general activities. Management and general activities are those that are not identifiable with a single program, fund-raising activity, or membership-development activity but that are indispensable to the conduct of those activities and to an organization's existence. They include oversight, business management, general recordkeeping, budgeting, financing, soliciting revenue from exchange transactions, such as government contracts and related administrative activities, and all management and administration except for direct conduct of program services or fund-raising activities. Disseminating information to inform the public of the organization's "stewardship" of contributed funds, announcements concerning appointments, and the annual report, among other activities, are management and general activities, as are soliciting funds other than contributions, including exchange transactions (whether program-related or not).

Medium. A medium is a means of mass communication, such as direct mail, direct response advertising, or television.

Membership-development activities. Membership-development activities include soliciting for prospective members and membership dues, membership relations, and similar activities. If there are no significant benefits or duties connected with membership, however, the substance of membership-development activities may, in fact, be fund-raising.

Program activities. Program activities are the activities that result in goods or services being distributed to beneficiaries, customers, or members that fulfill the purposes or mission for which the organization exists. Those services are the major purpose for and the major output of the organization and often relate to several major programs. For example, a large university may have programs for student instruction, research, and patient care, among others. Similarly, a health and welfare organization may have programs for health and family services, research, disaster relief, and public education, among others.

Location	*GASB Codification Reference 2016-17*
Paragraph .07	Co5.801, Ho5.804
Paragraph .08	Co5.802, Ho5.805
Paragraph .09	Co5.803, Ho5.806
Paragraph .10	Co5.804, Ho5.807
Footnote 5	Co5 footnote 4, Ho5 footnote 8
Footnote 6	Co5 footnote 5, Ho5 footnote 9
Footnote 7	Co5 footnote 6, Ho5 footnote 10
Footnote 8	Co5 footnote 7, Ho5 footnote 11
Paragraph .11	Co5.805, Ho5.808
Paragraph .12	Co5.806, Ho5.809
Paragraph .13	Co5.807, Ho5.810
Paragraph .14	Co5.808, Ho5.811
Footnote 9	Co5 footnote 8, Ho5 footnote 12
Paragraph .15	Co5.809, Ho5.812
Paragraph .16	Co5.810, Ho5.813
Paragraph .17	Co5.811, Ho5.814
Paragraph .18	Co5.812, Ho5.815
Paragraph .19	Co5.813, Ho5.816
Paragraph .30	Co5.814-1–.814-12, Ho5.817-1–.817-12

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Appendix A

Acronyms and Abbreviations

This appendix is nonauthoritative and is included for informational purposes only.

AICPA—American Institute of Certified Public Accountants

APB—Accounting Principles Board

ASB—Auditing Standards Board of the AICPA

AT-C section—Clarified Attestation Standards section of the AICPA's *Professional Standards*

AU-C section—Clarified Auditing Standards section of the AICPA's *Professional Standards*

BAN—Bond anticipation note

CAFR—Comprehensive Annual Financial Report

CMBS—Commercial Mortgage-Backed Security

CDO—Collateralized Debt Obligation

CMO—Collateralized Mortgage Obligation

EMMA—Electronic Municipal Market Access

ERISA—Employee Retirement Income Security Act

ET section—Ethics Standards section of the AICPA's *Professional Standards*

FAA—U.S. Federal Aviation Administration

FASB—Financial Accounting Standards Board

FDS—U.S. Department of Housing and Urban Development's Financial Data Schedule

FinREC—Financial Reporting Executive Committee of the AICPA

GAAP—Generally accepted accounting principles

GAAS—Generally accepted auditing standards

GASB—Governmental Accounting Standards Board

GASB IG 2015-1—GASB *Implementation Guide No. 2015-1*

GWFS—Government-wide financial statements

HUD—U.S. Department of Housing and Urban Development

IBNR—Incurred but not reported (claims)

IRC—Internal Revenue Code

MD&A—Management's discussion and analysis

MFBA—Measurement focus and basis of accounting

NAV—Net Asset Value

NCGA—National Council on Governmental Accounting

OI—Other information

OMB—U.S. Office of Management and Budget

OPEB—Postemployment benefits other than pensions

PCAOB—Public Company Accounting Oversight Board

PERS—Public Employees Retirement System

PFC—Passenger facility charge

PHA—Public housing authority

PILOT—Payment in lieu of taxes

QSTP—Qualified state tuition program

REIT—Real Estate Investment Trust

RMBS—Residential Mortgage-Backed Security

RSI—Required supplementary information

SAS—Statement on Auditing Standards

SEC—Securities and Exchange Commission

SGIC—Synthetic Guaranteed Investment Contract

SI—Supplementary information other than required supplementary information

SOP—Statement of Position by committees of the AICPA

SSAE—Statement on Standards for Attestation Engagements

TB—Technical Bulletins of GASB

UBIT—Federal unrelated business income taxes

Uniform Guidance—Title 2 U.S. *Code of Federal Regulations* Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards*

USDA—U.S. Department of Agriculture

Yellow Book—*Government Auditing Standards*, issued by the Comptroller General of the United States

Appendix B

Category B Guidance

This appendix is nonauthoritative and is included for informational purposes only.

As discussed in chapter 1, "Overview and Introduction," GASB Statement No. 76, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*, establishes the hierarchy of generally accepted accounting principles (GAAP) for state and local governments. The GAAP hierarchy consists of sources of accounting principles used in the preparation of financial statements so that they are presented in accordance with GAAP and the framework for selecting those principles. Sources of category B guidance include AICPA literature specifically made applicable to state and local governmental entities and cleared by GASB, such as certain provisions in this guide. This appendix lists the category B guidance that is included in this guide. Category B guidance appears in orange font in this guide.

Location	***Nature of Guidance***	***GASB Codification Reference 2016–17***
Paragraph 1.01 and footnote 4	Definition of *government*	1000.801; 1000 fn 4
Paragraph 5.10, last sentence	Annual calculation of an arbitrage liability	1500.801
Paragraph 5.28	Overdrafts of internal investment pools and of cash accounts	1800.801–.802
Paragraph 5.30[1]	Interfund balances relating to agency funds with negative cash balances	1800.803
Paragraph 6.81, second sentence	Reporting nonoperating revenue for certain nonexchange revenues for operating purposes or for operating purposes or capital outlay at the recipient's discretion	N50.802; 1800.804; 2200.801; P80.804
Paragraph 8.17	When to report the issuance of debt	1500.802

(continued)

[1] The category B guidance in this paragraph will be affected by GASB Statement No. 84, *Fiduciary Activities*, upon its effective date. The statement is effective for fiscal years beginning after December 15, 2018.

Location	*Nature of Guidance*	*GASB Codification Reference 2016–17*
Paragraph 8.38, fourth sentence	Reporting revenue for fees received for administering pass-through grants	N50.801
Paragraph 8.72	Accounting for customer deposits for utility services	Ut5.801; P80.806
Paragraph 8.103	Accounting for payments to the refunding agent for current refundings as an other financing use	D20.801
Paragraph 8.105, second sentence	Definition of *commitment*	2300.801
Paragraph 11.16, last sentence	Disclosure in the notes to the financial statements if a budget is not adopted for the general or a major special revenue fund because it is not legally required when a government presents required budgetary comparison information in the basic financial statements	1700.801; 2300.802; 2400.801
Paragraph 12.31, third sentence	Revenues and expenses that financing authorities should report in their financial statements	P80.805; C65.801
Paragraph 12.71, second sentence	Reporting nonoperating revenue for appropriations for operating purposes or for operating purposes or capital outlay at the recipient's discretion	1800.804; 2200.801; N50.802; P80.804
Paragraph 12.108, first sentence	Accounting for lottery prize costs	P80.807; Sp20.801
Paragraph 12.109	Accounting for prize liabilities for which annuities have been purchased	P80.808–.809; Sp20.802–.803
Paragraph 12.110, first sentence	Using present value to measure lottery prize liabilities	P80.810; Sp20.804

Location	***Nature of Guidance***	***GASB Codification Reference 2016–17***
Paragraph 16.73, first bullet, last sentence	Disclosure in the notes to the financial statements if a budget is not adopted for the general or a major special revenue fund because it is not legally required when a government presents required budgetary comparison information in the basic financial statements	1700.801; 2200.802; 2400.801
Supplement	Statement of Position 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising* (AICPA, *Professional Standards*, ACC sec. 10)	See Supplement for GASB Codification References

Appendix C

Overview of Statements on Quality Control Standards

This appendix is nonauthoritative and is included for informational purposes only.

This appendix is a partial reproduction of chapter 1 of the AICPA practice aid *Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, available at www.aicpa.org/interestareas/frc/pages/enhancingauditqualitypracticeaid.aspx.

This appendix highlights certain aspects of the quality control standards issued by the AICPA. If appropriate, readers should also refer to the quality control standards issued by the PCAOB, available at www.pcaobus.org/Standards/QC/Pages/default.aspx.

1.01 The objectives of a system of quality control are to provide a CPA firm with reasonable assurance[1] that the firm and its personnel comply with professional standards and applicable regulatory and legal requirements, and that the firm or engagement partners issue reports that are appropriate in the circumstances. QC section 10, *A Firm's System of Quality Control* (AICPA, *Professional Standards*), addresses a CPA firm's responsibilities for its system of quality control for its accounting and auditing practice. That section is to be read in conjunction with the AICPA Code of Professional Conduct and other relevant ethical requirements.

1.02 A system of quality control consists of policies designed to achieve the objectives of the system and the procedures necessary to implement and monitor compliance with those policies. The nature, extent, and formality of a firm's quality control policies and procedures will depend on various factors such as the firm's size; the number and operating characteristics of its offices; the degree of authority allowed to, and the knowledge and experience possessed by, firm personnel; and the nature and complexity of the firm's practice.

Communication of Quality Control Policies and Procedures

1.03 The firm should communicate its quality control policies and procedures to its personnel. Most firms will find it appropriate to communicate their policies and procedures in writing and distribute them, or make them available electronically, to all professional personnel. Effective communication includes the following:

- A description of quality control policies and procedures and the objectives they are designed to achieve

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[1] The term *reasonable assurance*, which is defined as a high, but not absolute, level of assurance, is used because absolute assurance cannot be attained. Paragraph .53 of QC section 10, *A Firm's System of Quality Control* (AICPA, *Professional Standards*), states, "Any system of quality control has inherent limitations that can reduce its effectiveness."

- The message that each individual has a personal responsibility for quality
- A requirement for each individual to be familiar with and to comply with these policies and procedures

Effective communication also includes procedures for personnel to communicate their views or concerns on quality control matters to the firm's management.

Elements of a System of Quality Control

1.04 A firm must establish and maintain a system of quality control. The firm's system of quality control should include policies and procedures that address each of the following elements of quality control identified in paragraph .17 of QC section 10:

- Leadership responsibilities for quality within the firm (the "tone at the top")
- Relevant ethical requirements
- Acceptance and continuance of client relationships and specific engagements
- Human resources
- Engagement performance
- Monitoring

1.05 The elements of quality control are interrelated. For example, a firm continually assesses client relationships to comply with relevant ethical requirements, including independence, integrity, and objectivity, and policies and procedures related to the acceptance and continuance of client relationships and specific engagements. Similarly, the human resources element of quality control encompasses criteria related to professional development, hiring, advancement, and assignment of firm personnel to engagements, all of which affect policies and procedures related to engagement performance. In addition, policies and procedures related to the monitoring element of quality control enable a firm to evaluate whether its policies and procedures for each of the other five elements of quality control are suitably designed and effectively applied.

1.06 Policies and procedures established by the firm related to each element are designed to achieve reasonable assurance with respect to the purpose of that element. Deficiencies in policies and procedures for an element may result in not achieving reasonable assurance with respect to the purpose of that element; however, the system of quality control, as a whole, may still be effective in providing the firm with reasonable assurance that the firm and its personnel comply with professional standards and applicable regulatory and legal requirements and that the firm or engagement partners issue reports that are appropriate in the circumstances.

1.07 If a firm merges, acquires, sells, or otherwise changes a portion of its practice, the surviving firm evaluates and, as necessary, revises, implements, and maintains firm-wide quality control policies and procedures that are appropriate for the changed circumstances.

Leadership Responsibilities for Quality Within the Firm (the "Tone at the Top")

1.08 The purpose of the leadership responsibilities element of a system of quality control is to promote an internal culture based on the recognition that quality is essential in performing engagements. The firm should establish and maintain the following policies and procedures to achieve this purpose:

- Require the firm's leadership (managing partner, board of managing partners, CEO, or equivalent) to assume ultimate responsibility for the firm's system of quality control.
- Provide the firm with reasonable assurance that personnel assigned operational responsibility for the firm's quality control system have sufficient and appropriate experience and ability to identify and understand quality control issues and develop appropriate policies and procedures, as well as the necessary authority to implement those policies and procedures.

1.09 Establishing and maintaining the following policies and procedures assists firms in recognizing that the firm's business strategy is subject to the overarching requirement for the firm to achieve the objectives of the system of quality control in all the engagements that the firm performs:

- Assign management responsibilities so that commercial considerations do not override the quality of the work performed.
- Design policies and procedures addressing performance evaluation, compensation, and advancement (including incentive systems) with regard to personnel to demonstrate the firm's overarching commitment to the objectives of the system of quality control.
- Devote sufficient and appropriate resources for the development, communication, and support of its quality control policies and procedures.

Relevant Ethical Requirements

1.10 The purpose of the relevant ethical requirements element of a system of quality control is to provide the firm with reasonable assurance that the firm and its personnel comply with relevant ethical requirements when discharging professional responsibilities. Relevant ethical requirements include independence, integrity, and objectivity. Establishing and maintaining policies such as the following assist the firm in obtaining this assurance:

- Require that personnel adhere to relevant ethical requirements such as those in regulations, interpretations, and rules of the AICPA, state CPA societies, state boards of accountancy, state statutes, the U.S. Government Accountability Office, and any other applicable regulators.
- Establish procedures to communicate independence requirements to firm personnel and, where applicable, others subject to them.
- Establish procedures to identify and evaluate possible threats to independence and objectivity, including the familiarity threat that may be created by using the same senior personnel on an audit

or attest engagement over a long period of time, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards.

- Require that the firm withdraw from the engagement if effective safeguards to reduce threats to independence to an acceptable level cannot be applied.
- Require written confirmation, at least annually, of compliance with the firm's policies and procedures on independence from all firm personnel required to be independent by relevant requirements.
- Establish procedures for confirming the independence of another firm or firm personnel in associated member firms who perform part of the engagement. This would apply to national firm personnel, foreign firm personnel, and foreign-associated firms.[2]
- Require the rotation of personnel for audit or attest engagements where regulatory or other authorities require such rotation after a specified period.

Acceptance and Continuance of Client Relationships and Specific Engagements

1.11 The purpose of the quality control element that addresses acceptance and continuance of client relationships and specific engagements is to establish criteria for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for a client. A firm's client acceptance and continuance policies represent a key element in mitigating litigation and business risk. Accordingly, it is important that a firm be aware that the integrity and reputation of a client's management could reflect the reliability of the client's accounting records and financial representations and, therefore, affect the firm's reputation or involvement in litigation. A firm's policies and procedures related to the acceptance and continuance of client relationships and specific engagements should provide the firm with reasonable assurance that it will undertake or continue relationships and engagements only where it

- is competent to perform the engagement and has the capabilities, including the time and resources, to do so;
- can comply with legal and relevant ethical requirements;
- has considered the client's integrity and does not have information that would lead it to conclude that the client lacks integrity; and
- has reached an understanding with the client regarding the services to be performed.

1.12 This assurance should be obtained before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client.

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[2] A *foreign-associated firm* is a firm domiciled outside of the United States and its territories that is a member of, correspondent with, or similarly associated with an international firm or international association of firms.

Establishing and maintaining policies such as the following assist the firm in obtaining this assurance:

- Evaluate factors that have a bearing on management's integrity and consider the risk associated with providing professional services in particular circumstances.[3]
- Evaluate whether the engagement can be completed with professional competence; undertake only those engagements for which the firm has the capabilities, resources, and professional competence to complete; and evaluate, at the end of specific periods or upon occurrence of certain events, whether the relationship should be continued.
- Obtain an understanding, preferably in writing, with the client regarding the services to be performed.
- Establish procedures on continuing an engagement and the client relationship, including procedures for dealing with information that would have caused the firm to decline an engagement if the information had been available earlier.
- Require documentation of how issues relating to acceptance or continuance of client relationships and specific engagements were resolved.

Human Resources

1.13 The purpose of the human resources element of a system of quality control is to provide the firm with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary (*a*) to perform its engagements in accordance with professional standards and regulatory and legal requirements, and (*b*) to enable the firm to issue reports that are appropriate in the circumstances. Establishing and maintaining policies such as the following assist the firm in obtaining this assurance:

- Recruit and hire personnel of integrity who possess the characteristics that enable them to perform competently.
- Determine capabilities and competencies required for an engagement, especially for the engagement partner, based on the characteristics of the particular client, industry, and kind of service being performed. Specific competencies necessary for an engagement partner are discussed in paragraph .A27 of QC section 10.
- Determine the capabilities and competencies possessed by personnel.

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[3] Such considerations would include the risk of providing professional services to significant clients or to other clients for which the practitioner's objectivity or the appearance of independence may be impaired. In broad terms, the significance of a client to a member or a firm refers to relationships that could diminish a practitioner's objectivity and independence in performing attest services. Examples of factors to consider in determining the significance of a client to an engagement partner, office, or practice unit include (*a*) the amount of time the partner, office, or practice unit devotes to the engagement, (*b*) the effect on the partner's stature within the firm as a result of his or her service to the client, (*c*) the manner in which the partner, office, or practice unit is compensated, or (*d*) the effect that losing the client would have on the partner, office, or practice unit.

- Assign the responsibility for each engagement to an engagement partner.
- Assign personnel based on the knowledge, skills, and abilities required in the circumstances and the nature and extent of supervision needed.
- Have personnel participate in general and industry-specific continuing professional education and professional development activities that enable them to accomplish assigned responsibilities and satisfy applicable continuing professional education requirements of the AICPA, state boards of accountancy, and other regulators.
- Select for advancement only those individuals who have the qualifications necessary to fulfill the responsibilities they will be called on to assume.

Engagement Performance

1.14 The purpose of the engagement performance element of quality control is to provide the firm with reasonable assurance (*a*) that engagements are consistently performed in accordance with applicable professional standards and regulatory and legal requirements, and (*b*) that the firm or the engagement partner issues reports that are appropriate in the circumstances. Policies and procedures for engagement performance should address all phases of the design and execution of the engagement, including engagement performance, supervision responsibilities, and review responsibilities. Policies and procedures also should require that consultation takes place when appropriate. In addition, a policy should establish criteria against which all engagements are to be evaluated to determine whether an engagement quality control review should be performed.

1.15 Establishing and maintaining policies such as the following assist the firm in obtaining the assurance required relating to the engagement performance element of quality control:

- Plan all engagements to meet professional, regulatory, and the firm's requirements.
- Perform work and issue reports and other communications that meet professional, regulatory, and the firm's requirements.
- Require that work performed by other team members be reviewed by qualified engagement team members, which may include the engagement partner, on a timely basis.
- Require the engagement team to complete the assembly of final engagement files on a timely basis.
- Establish procedures to maintain the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation.
- Require the retention of engagement documentation for a period of time sufficient to meet the needs of the firm, professional standards, laws, and regulations.
- Require that

  - — consultation take place when appropriate (for example, when dealing with complex, unusual, unfamiliar, difficult, or contentious issues);
  - — sufficient and appropriate resources be available to enable appropriate consultation to take place;
  - — all the relevant facts known to the engagement team be provided to those consulted;
  - — the nature, scope, and conclusions of such consultations be documented; and
  - — the conclusions resulting from such consultations be implemented.

- Require that
  - — differences of opinion be dealt with and resolved;
  - — conclusions reached are documented and implemented; and
  - — the report not be released until the matter is resolved.
- Require that
  - — all engagements be evaluated against the criteria for determining whether an engagement quality control review should be performed;
  - — an engagement quality control review be performed for all engagements that meet the criteria; and
  - — the review be completed before the report is released.
- Establish procedures addressing the nature, timing, extent, and documentation of the engagement quality control review.
- Establish criteria for the eligibility of engagement quality control reviewers.

Monitoring

1.16 The purpose of the monitoring element of a system of quality control is to provide the firm and its engagement partners with reasonable assurance that the policies and procedures related to the system of quality control are relevant, adequate, operating effectively, and complied with in practice. Monitoring involves an ongoing consideration and evaluation of the appropriateness of the design, the effectiveness of the operation of a firm's quality control system, and a firm's compliance with its quality control policies and procedures. The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of the following:

- Adherence to professional standards and regulatory and legal requirements
- Whether the quality control system has been appropriately designed and effectively implemented
- Whether the firm's quality control policies and procedures have been operating effectively so that reports issued by the firm are appropriate in the circumstances

1.17 Establishing and maintaining policies such as the following assist the firm in obtaining the assurance required relating to the monitoring element of quality control:

- Assign responsibility for the monitoring process to a partner or partners or other persons with sufficient and appropriate experience and authority in the firm to assume that responsibility.
- Assign performance of the monitoring process to competent individuals.
- Require the performance of monitoring procedures that are sufficiently comprehensive to enable the firm to assess compliance with all applicable professional standards and the firm's quality control policies and procedures. Monitoring procedures consist of the following:
  - — Review of selected administrative and personnel records pertaining to the quality control elements.
  - — Review of engagement documentation, reports, and clients' financial statements.
  - — Summarization of the findings from the monitoring procedures, at least annually, and consideration of the systemic causes of findings that indicate that improvements are needed.
  - — Determination of any corrective actions to be taken or improvements to be made with respect to the specific engagements reviewed or the firm's quality control policies and procedures.
  - — Communication of the identified findings to appropriate firm management personnel.
  - — Consideration of findings by appropriate firm management personnel who should also determine that any actions necessary, including necessary modifications to the quality control system, are taken on a timely basis.
  - — Assessment of
    - the appropriateness of the firm's guidance materials and any practice aids;
    - new developments in professional standards and regulatory and legal requirements and how they are reflected in the firm's policies and procedures where appropriate;
    - compliance with policies and procedures on independence;
    - the effectiveness of continuing professional development, including training;
    - decisions related to acceptance and continuance of client relationships and specific engagements; and
    - firm personnel's understanding of the firm's quality control policies and procedures and implementation thereof.

- Communicate at least annually, to relevant engagement partners and other appropriate personnel, deficiencies noted as a result of the monitoring process and recommendations for appropriate remedial action.
- Communicate the results of the monitoring of its quality control system process to relevant firm personnel at least annually.
- Establish procedures designed to provide the firm with reasonable assurance that it deals appropriately with the following:
  - — Complaints and allegations that the work performed by the firm fails to comply with professional standards and regulatory and legal requirements.
  - — Allegations of noncompliance with the firm's system of quality control.
  - — Deficiencies in the design or operation of the firm's quality control policies and procedures, or noncompliance with the firm's system of quality control by an individual or individuals, as identified during the investigations into complaints and allegations.

    This includes establishing clearly defined channels for firm personnel to raise any concerns in a manner that enables them to come forward without fear of reprisal and documenting complaints and allegations and the responses to them.
- Require appropriate documentation to provide evidence of the operation of each element of its system of quality control. The form and content of documentation evidencing the operation of each of the elements of the system of quality control is a matter of judgment and depends on a number of factors, including the following, for example:
  - — The size of the firm and the number of offices.
  - — The nature and complexity of the firm's practice and organization.
- Require retention of documentation providing evidence of the operation of the system of quality control for a period of time sufficient to permit those performing monitoring procedures and peer review to evaluate the firm's compliance with its system of quality control, or for a longer period if required by law or regulation.

1.18 Some of the monitoring procedures discussed in the previous list may be accomplished through the performance of the following:

- Engagement quality control review
- Review of engagement documentation, reports, and clients' financial statements for selected engagements after the report release date
- Inspection[4] procedures

[4] *Inspection* is a retrospective evaluation of the adequacy of the firm's quality control policies and procedures, its personnel's understanding of those policies and procedures, and the extent of the firm's compliance with them. Although monitoring procedures are meant to be ongoing, they may include inspection procedures performed at a fixed point in time. Monitoring is a broad concept; inspection is one specific type of monitoring procedure.

Documentation of Quality Control Policies and Procedures

1.19 The firm should document each element of its system of quality control. The extent of the documentation will depend on the size, structure, and nature of the firm's practice. Documentation may be as simple as a checklist of the firm's policies and procedures or as extensive as practice manuals.

Appendix D

Schedule of Changes Made to the Text From the Previous Edition

This appendix is nonauthoritative and is included for informational purposes only.

As of March 1, 2017

This schedule of changes identifies areas in the text and footnotes of this guide that have been changed from the previous edition. Entries in the table of this appendix reflect current numbering, lettering (including that in appendix names), and character designations that resulted from the renumbering or reordering that occurred in the updating of this guide.

Reference	*Change*
General	Guide content included in shaded areas and "Guidance Update" boxes within the chapters, with related footnotes, have been included and updated to appropriately reflect guidance not yet effective as of the date of the guide. See the preface of this guide for more explanation to this "dual guidance" treatment.
General	Editorial changes, including rephrasing, may have been made in this guide to improve readability where necessary.
Preface	Revised.
Paragraph 1.01	Text box before paragraph deleted for the passage of time.
Paragraph 1.02	Revised to provide further understanding of the applicability of ERISA to governmental pension plans. This revision is not related to an issuance of authoritative guidance.
Paragraph 1.14	Revised for the passage of time.
Paragraphs 2.21 and 2.51	Revised for the passage of time and to reflect the issuance of GASB Statement No. 73, *Accounting and Financial Reporting for Pensions and Related Assets That Are Not within the Scope of GASB Statement 68, and Amendments to Certain Provisions of GASB Statements 67 and 68.*

(*continued*)

Reference	*Change*
Update 2-1	Revised for the passage of time.
Update 2-2	Added to reflect the issuance of GASB Statement No. 84, *Fiduciary Activities*.
Paragraphs 2.29, 2.43, and 2.51, and Table A-1 in paragraph 2.97	Revised to reflect the issuance of GASB Statement No. 74, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*.
Paragraph 2.21	Revised to reflect the issuance of GASB Statement No. 81, *Irrevocable Split-Interest Agreements*.
Former Update 2-2	Deleted for the passage of time.
Paragraph 2.47	Revised to reflect the issuance of GASB Statement No. 77, *Tax Abatement Disclosures*.
Update 2-3	Updated to reflect the issuance of GASB Statement Nos. 73 and 74.
Former Update 3-1	Deleted for the passage of time.
Paragraph 3.16	Paragraph revised and footnote 11 added to reflect the issuance of GASB Statement No. 80, *Blending Requirements for Certain Component Units an amendment of GASB Statement No. 14*.
Paragraph 4.01	Text box before paragraph revised for the passage of time.
Paragraph 4.12	Paragraph revised and former footnote 3 deleted for developments that are not related to an issuance of authoritative guidance.
Paragraph 4.49	Revised for the passage of time.
Paragraph 4.56	Revised to reflect the issuance of Statement on Standards for Attestation Engagements (SSAE) No. 18, *Attestation Standards: Clarification and Recodification* (AICPA, *Professional Standards*).
Paragraphs 4.61 and 4.138	Paragraphs revised and footnote 5 in paragraph 4.138 revised to reflect the issuance of GASB Statement No. 74.
Update 4-1	Added to reflect the issuance of GASB Statement No. 84.
Paragraphs 4.126, 4.131, and 4.137, and footnote 9 in 4.138	Revised for the passage of time.

Reference	*Change*
Paragraphs 5.24, 5.37, 5.39, 5.83, and 5.91, and heading before paragraph 5.99	Revised to reflect the issuance of GASB Statement No. 74.
Update 5-1	Added to reflect the issuance of GASB Statement No. 84.
Former Update 5-1	Deleted for the passage of time.
Former paragraph 5.39	Deleted for the passage of time.
Former Update 5-2	Deleted for the passage of time.
Footnote 3 in paragraph 5.75, and paragraph 5.122	Revised to reflect the issuance of SSAE No. 18.
Update 6-1	Revised for the passage of time.
Paragraphs 6.02 and 6.44	Revised to reflect the issuance of GASB Statement No. 73.
Update 6-2	Added to reflect the issuance of GASB Statement No. 84.
Former Update 6-2	Deleted for the passage of time.
Paragraph 6.44	Revised for developments that are not related to an issuance of authoritative guidance.
Paragraph 6.84	Revised to reflect the issuance of GASB Statement No. 74.
Former Update 6-3	Deleted for the passage of time.
Paragraph 6.88	Revised to reflect the issuance of GASB Statement No. 77.
Paragraph 6.91	Revised to reflect the issuance of SSAE No. 18.
Footnote 3 in paragraph 7.11	Revised to reflect the issuance of GASB Statement No. 74.
Former footnote 4 in paragraph 7.11	Deleted for the passage of time.
Update 7-1	Added to reflect the issuance of GASB Statement No. 84.
Paragraph 7.35	Revised to provide further understanding of the forms of capital asset financing agreements governments enter into that is not related to an issuance of authoritative guidance.

(*continued*)

Reference	*Change*
Update 7-2	Added to reflect the issuance of GASB Statement No. 83, *Certain Asset Retirement Obligations*.
Paragraph 7.89	Revised to reflect the issuance of SSAE No. 18.
Update 8-1	Added to reflect the issuance of GASB Statement No. 83.
Update 8-2	Added to reflect the issuance of GASB Statement No. 84.
Paragraph 8.04	Revised to reflect the issuance of GASB Statement Nos. 73 and 81.
Update 8-3	Revised for the passage of time.
Paragraph 8.07	Revised for developments that are not related to an issuance of authoritative guidance.
Footnotes 8 and 9 in paragraph 8.13	Revised to reflect the issuance of GASB Statement Nos. 73 and 74, and for the passage of time.
Paragraphs 8.20 .21	Revised to reflect the issuance GASB Statement No. 73.
Paragraph 8.21	Revised to reflect the issuance of GASB Statement No. 78, *Pensions Provided through Certain Multiple-Employer Defined Benefit Pension Plans.*
Former Update 8-2	Deleted for the passage of time.
Update 8-4	Revised for the passage of time.
Former paragraphs 8.22 .28	Paragraphs deleted to reflect updates to chapter 13.
Paragraphs 8.23 .24, 8.29, 8.34, 8.112, and 8.114	Revised to reflect the issuance of GASB Statement No. 74.
Former footnote 25 in 8.117	Deleted to reflect the issuance of GASB Statement No. 74.
Paragraph 8.123	Revised to reflect the issuance of SSAE No. 18.
Paragraph 8.127	Revised for developments not related to the issuance of authoritative guidance.
Update 9-1	Added to reflect the issuance of GASB Statement No. 84.
Paragraph 9.06	Revised for developments that are not related to an issuance of authoritative guidance.

Reference	*Change*
Update 10-1	Added to reflect the issuance of GASB Statement No. 84.
Paragraph 10.22	Revised to reflect the issuance of GASB Statement No. 74.
Former Update 10-1	Deleted for the passage of time.
Paragraph 11.20	Revised for the passage of time.
Paragraph 12.01	Text box before paragraph revised for the passage of time.
Update 12-1	Added to reflect the issuance of GASB Statement No. 84.
Paragraph 12.16	Revised to reflect the issuance of SSAE No. 18.
Former Update 12-1	Deleted for the passage of time.
Paragraphs 12.40 and 12.45	Revised to reflect the issuance of GASB Statement No. 74.
Paragraph 12.41	Revised for developments that are not related to an issuance of authoritative guidance.
Former Update 12-2	Deleted for the passage of time.
Paragraph 12.44	Revised to reflect the issuance of GASB Statement No. 73.
Former paragraphs 12.46 .53 and former footnote 18 in former paragraph 12.51	Deleted to reflect the issuance of GASB Statement No. 74.
Paragraphs 12.54 and 12.65	Revised to reflect the issuance of GASB Statement No. 81.
Paragraph 12.82	Revised for the passage of time.
Paragraph 12.83	Added to reflect the issuance of GASB Statement No. 81.
Former Updates 13-1, 13-2, 13-3, and all references thereto	Deleted for the passage of time.
Paragraph 13.02	Emphasis point before paragraph revised to reflect the issuance of GASB Statement No. 73.
Footnote 1 in paragraph 13.02	Revised to reflect the development of the new chapter 14.
Paragraph 13.03, former footnote 2 in paragraph 13.03	Revised and deleted, respectively, to reflect the issuance of GASB Statement No. 73.

(*continued*)

Reference	*Change*
Paragraph 13.04, former 3 in paragraph 13.03	Revised and deleted, respectively to reflect the issuance of GASB Statement Nos. 73 and 78.
Paragraphs 13.05, 13.08, 13.15, and 13.17	Revised to reflect the issuance of GASB Statement No. 73.
Update 13-1	Added to reflect the issuance of GASB Statement No. 84.
Footnote 11 in paragraph 13.37	Added for developments that are not related to an issuance of authoritative guidance.
Paragraph 13.59, exhibit 13-3, and paragraph 13.63	Revised to reflect the issuance of SSAE No. 18.
Former paragraph 13.87*j*	Deleted for the passage of time.
Paragraph 13.96	Emphasis point before paragraph revised to reflect the issuance of GASB Statement No. 73.
Paragraphs 13.96 .97 and 13.99 .101	Revised to reflect the issuance of GASB Statement No. 73.
Paragraph 13.101	Revised to reflect the issuance of GASB Implementation Guide No. 2016-1, *Implementation Guidance Update 2016*.
Paragraphs 13.103 .105, 13.108, and 13.112	Revised to reflect the issuance of GASB Statement No. 73.
Paragraph 13.118	Revised to reflect the issuance of SSAE No. 18.
Paragraph 13.123	Emphasis point before paragraph revised to reflect the issuance of GASB Statement No. 73.
Paragraph 13.128	Revised to reflect the issuance of SSAE No. 18.
Paragraphs 13.130 .131, 13.133 .134, 13.136, and 13.141 .142	Revised to reflect the issuance of GASB Statement No. 73.
Paragraph 13.131	Revised for developments that are not related to an issuance of authoritative guidance.
Paragraph 13.136	Revised to reflect the issuance of SSAE No. 18.
Paragraphs 13.163 .165	Revised to reflect the issuance of GASB Statement No. 73.

Reference	*Change*
Paragraphs 13.173-.174	Revised for developments that are not related to an issuance of authoritative guidance.
Paragraph 13.178*h*	Added for developments that are not related to an issuance of authoritative guidance.
Paragraph 13.179	Emphasis points added for developments that are not related to an issuance of authoritative guidance.
Paragraph 13.181	Paragraphs A-17 and A-21 in appendix A revised to reflect the issuance of SSAE No. 18.
Paragraph 13.182	Emphasis point added in paragraph B-16 of appendix B, exhibits B-2 and B-3 of appendix B revised, emphasis point added in paragraph B-19 of appendix B, footnote 4 added to exhibit B-2 of appendix B, footnote ** added to exhibit B-3 of appendix B, footnote 5 added to example B-1 of appendix B, and footnote 6 of example B-1 of appendix B revised for other developments that are not related to an issuance of authoritative guidance.
Chapter 14	Added to reflect the issuance of GASB Statement Nos. 74 and 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*. This change goes beyond a conforming change and has been approved in accordance with applicable AICPA requirements.
Paragraph 15.05	Revised to reflect the issuance of GASB Statement No. 72, *Fair Value Measurement and Application*, and No. 77.
Paragraph 15.11	Revised to reflect the issuance of GASB Statement No. 77.
Paragraph 15.18	Revised for the passage of time.
Update 15-1	Added to reflect the issuance of Statement on Auditing Standards (SAS) No. 132, *The Auditor s Consideration of an Entity s Ability to Continue as a Going Concern* (AICPA, *Professional Standards*).

(*continued*)

Reference	*Change*
Paragraph 16.01	Text box before paragraph revised for the passage of time.
Paragraphs 16.05, 16.12 .13, 16.25, and 16.46, footnote 5 in paragraph 16.12, footnote 12 in paragraph 16.46, and paragraphs 16.47 .50 and 16.65	Revised for the passage of time.
Update 16-1	Added to reflect the issuance of GASB Statement No. 84.
Paragraph 16.103	Revised footnote 2 in example A-1, footnote 19 in example A-4, example A-13, example A-16 and example A-17 for changes in industry practice or developments not related to the issuance of authoritative guidance.
Paragraph 16.103	Revised footnote 8 in example A-1 and footnote 19 in example A-4 for the passage of time.
Paragraphs 17.02 and 17.05	Revised for developments that are not related to an issuance of authoritative guidance.
Paragraphs 17.02 and 17.14, and footnote 3 in example A-1 of paragraph 17.17	Revised for the passage of time.
Update 17-1	Added to reflect the issuance of SAS No. 132.
Paragraphs 18.07, 18.09, 18.14, and 18.23; and footnote 14 in paragraph 18.23	Revised to reflect the issuance of SSAE No. 18.
Appendixes A and B	Updated.
Index of Pronouncements and Other Technical Guidance	Updated.
Subject Index	Updated.

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