AUDIT GUIDE FOR AUDITS OF STATE AND LOCAL GOVERNMENTAL UNITS

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*This paper describes an audit guide published by a committee of the American Institute of CPAs. The author wrote the first draft of the guide and participated in its completion as a member of the committee.
The American Institute of CPAs until very recently has left to industry groups the development of accounting principles in the field of governmental and non-profit accounting. Two major bodies of the Institute have published literature on accounting principles. Major contributions of the Committee on Accounting Procedures have included fifty-one accounting research bulletins; the Accounting Principles Board, thirty-one opinions. All of these were specifically addressed to business enterprises.

Within the past two years, however, committees of the Institute have produced a total of four audit guides, addressing accounting principles as well as auditing and reporting. The first of these was on hospitals. (See an article in the March, 1973 Journal of Accountancy by M. J. Gross, Jr., CPA.) The second and third were on Colleges and Universities and on Voluntary Health and Welfare Organizations. (Again, see an article by M. J. Gross, in the April, 1974 Journal). The most recent and the subject of this article is a guide for audits of State and Local Governmental Units.

A. A Brief History

The guide was a project of the Committee on Governmental Accounting and Auditing. Subsequently, it has had the approval of the Accounting Principles Board in terms of accounting principles and of the Auditing Standards Division in terms of auditing and reporting. It is, therefore, the Institute's authoritative pronouncement for governmental units below the level of the Federal Government, effective for periods beginning on or after January 1, 1974.
Intensive work on the guide was started in 1969. It is amusing to observe that the Committee estimated a 25 to 40 page booklet and a one year time table. The actual guide is 160 pages, the largest Institute guide so far, and the actual time table has been five years. From the beginning the intention was to write the guide as an endorsement and supplement to the "blue book" or "GAAFR", i.e. the book entitled Governmental Accounting, Auditing and Financial Reporting, published in 1968 by the National Committee on Governmental Accounting (NCGA), largely under the auspices of the Municipal Financial Officers Association (MFOA) of the United States and Canada.

The NCGA was originally formed in 1934 as the National Committee on Municipal Accounting; in 1949 it changed its name to the present title. One of its essential purposes has been a series of publications in the field of governmental accounting. The American Institute has been one of the organizations actively represented on the NCGA, including recent participation by the Chairman of the Committee on Governmental Accounting and Auditing.

The American Institute has never exercised its prerogative of officially endorsing the publications of the National Committee on Governmental Accounting in the governmental field. In a broad sense, however, it is believed to have been generally accepted within the accounting profession, in the absence of definitive literature published by the Institute, that the earlier publications of NCGA and, more recently (March, 1968), Governmental Accounting, Auditing, and Financial Reporting (GAAFR), should be considered as authoritative literature in the governmental field. Accordingly, the audit guide refers to GAAFR as "an authoritative publication in the area of accounting for governmental units." Further, the guide will state, except as specifically modified therein, that GAAFR's principles constitute generally accepted accounting principles.
B. Generally Accepted Accounting Principles for Governmental Units

The term "generally accepted accounting principles" is an overall concept, but some principles are different for different types of entities. In an auditor's opinion, since the type of unit is already identified by the name on the report, the term "generally accepted accounting principles" is sufficient.

As stated above, the guide relies on GAAP as an authoritative source of accounting principles. Particularly, thirteen principles stated by the NCGA are the principal framework for distinctive features applicable to government. These are reproduced in Appendix A of the guide and are the main basis for the discussion in the chapters on accounting and budgeting.

In discussing these principles, the guide differs in some detailed respects from positions expressed in GAAP. These differences were discussed with representatives of the NCGA (especially from MFOA) during the writing of the guide, and accommodations were reached.

One difference is more of style than of substance. The guide has organized the thirteen principles into seven "combined principles". A list of these is as follows:

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On the basis of the Committee's study, the following principles (seven of the thirteen) in GAAFR appear to be well stated, with few changes recommended:

Nos. 4-7  Fund accounting
No. 7 (part)  Long-term liabilities
Nos. 11-13  Financial statements

Relatively more modifications pertain to the remaining six GAAFR principles.

Nevertheless, the guide includes some explanations and changes, or recognizes alternative practices in connection with all seven combined principles. The major such modifications are as follows:

1. **Fund Accounting**

   In fund accounting, the guide undertook to expand on the topic of inter-fund transfers. The NCGA did not address the topic of interfund transfer to any extent. The position of the guide is that most interfund transfers should be reported as revenue and expenditures of the respective funds. Four kinds of transfers are identified. Of these, one nonrecurring type is identified as possibly appropriate for Fund Balance recording. (This precipitated one of the qualified assents to the guide. One member felt strongly that all transfers should be budgeted and recorded as revenue and expenditures.)

   Without elaboration, controversial topics on which the guide takes a position would include the following that bear on fund accounting:

   (1) Is fund accounting obsolete? The answer is that it is certainly not obsolete for the time being, although accounting for larger units does involve significant segments of accounting where the budget is primary and funds are secondary.
(2) What is the entity? Is it the fund or is it the governmental unit as a whole? The answer is that the means for reporting on the unit is by fund and account group. It is possible to reword the opinion to refer to the unit as a whole. If so, the measure of materiality remains at the fund level.

(3) What is a minimum report? Can an unqualified opinion be given on one fund standing alone? Conversely, can one fund be omitted without reference to that fact? The answer is that misleading inferences must be avoided. There is specific coverage on this in the guide.

2. **Budgets and Budgetary Accounting**

Budgets are often required by legal provisions affecting governmental operations and have significant impact on accounting and reporting for governmental units. Therefore, to properly perform an audit, it is necessary for the auditor to understand the budgeting practices and procedures of governmental units, including the interrelationship of budgeting, accounting and reporting.

Budgetary accounting is a basic and distinctive feature of governmental accounting and is discussed in at least three of GAAFR's basic principles.

The NCGA, no doubt influenced by legal provisions, tends to refer to budget in terms of all funds. The guide considers as "budgetary funds" primarily the general and special revenue funds.

The guide includes an entire chapter on "Budgeting Practices and Procedures" because of the unquestionable importance of budgets in government.

One of the most controversial issues within the AICPA Committee was whether or not there is a "budget principle." That is, whether adopting a
budget and reporting budgetary amounts in the financial statements is a matter of generally accepted accounting principles, or whether it is merely a good management procedure or a matter of legal compliance where the law requires it.

The guide's position is that, for financial reporting purposes, the statement of revenues and expenditures of the general fund and certain special revenue funds (the ones that comprise a substantial part of the total expenditures and are for major functions) should include a comparison with a formal budget in order to be in conformity with generally accepted accounting principles. This requirement in terms of GAAP would not extend to the other six kinds of funds out of the total of eight.

Without elaboration, in reaching this conclusion the Committee was persuaded by the fact that it is clearly inherent in government that a predetermined standard against which financial performance can be measured should be established for at least those governmental activities that serve and are financed by the broad general public. It follows that accounting in accordance with objectives will necessitate reporting those objectives, in this instance in budgetary form, in conjunction with the actual results.

3. Legal Compliance

In the legal compliance principle, the guide reverses the emphasis on legal compliance versus accounting principles, in terms of financial reporting. GAAFR specifically provides, both with respect to accounting for the operations of a fund and the presentation of financial statements, that legal provisions must take precedence over accounting principles whenever a conflict between the two exists. The Committee recognizes that the first responsibility of governmental officials is to comply with the law and that one of the principal
purposes of the accounting system is to enable ready disclosure of compliance with appropriate legal provisions. However, this requirement for compliance to be expressed in the accounting system does not obviate generally accepted accounting principles for purposes of reporting financial position and results of operations of a given governmental unit.

In financial reporting, the AICPA Committee concluded that, in the event of conflict between legal provisions and generally accepted accounting principles, the latter should take precedence. Accordingly, the audit guide will set forth the following restatement of the legal compliance accounting principle:

A governmental accounting system should incorporate such accounting information in its records as necessary to make it possible to both (a) show compliance with all applicable legal provisions and (b) present fairly the financial position and results of operations of the respective funds and financial position of the self-balancing account groups of the governmental units in conformity with generally accepted accounting principles. Where these two objectives are in conflict, generally accepted accounting principles take precedence in financial reporting.

Where there is a need to report the compliance of financial transactions with legal requirements and it can be reported in supplemental schedules, this form should be used.

The independent auditor should issue an opinion as to the fair presentation of financial statements prepared in conformity with generally accepted accounting principles, consistently applied, and, as to such supplemental schedules, should express an opinion only to the effect that they were prepared in conformance with applicable legal requirements.

In instances where financial statements are not presented in conformity with generally accepted accounting principles, the independent auditor would be precluded from expressing an unqualified opinion and should refer to Statements on Auditing Standards No. 1, issued by the AICPA, for guidance with respect to the appropriate wording to be used in such an opinion.
4. **Basis of Accounting**

Basis of accounting is a topic requiring considerable clarification of the material in GAAFR. The guide agrees with the NCGA in recommending accrual basis for enterprise, trust, capital projects, special assessment, and intragovernmental service, five of the eight funds; and modified accrual for the other three, general, special revenue, and debt service funds. There are, however, some differences in terms of detail.

In an historical sense, two basic methods of accounting have been widely used in both the commercial and nonprofit organizational fields, i.e., cash basis and accrual basis. The influence of the accounting profession and the regulatory authorities on the accounting practices of business and industry, however, have to date achieved almost universal adoption of the accrual basis for reporting purposes in the field of commercial accounting, because only this method results in a fair presentation of financial position and the results of operations in a given accounting period. Hence, cash-basis accounting has been completely disavowed for fair presentation purposes in commercial accounting and now, both in GAAFR and in the audit guide, it has been similarly disavowed for use by governmental units.

With respect to basis of accounting, two significant distinctions between commercial and governmental accounting should be made clear. Although enterprise and intragovernmental service funds in governmental units are similar to commercial enterprises and follow generally the same accounting principles, the remaining six standard funds do not follow commercial accounting practices. Of these six, three in particular--general, special revenue, and debt service funds--comprise those most characteristic of the basic governmental operation, i.e., service oriented and characterized by the absence of the profit motive. These funds are
commonly identified as budgetary funds because the budget is both the plan and the control device for their operation.

Operations within the budgetary funds represent primarily the provision of resources and the expenditure of such resources to provide services. Ordinarily there is no causative relation between expenditures and resources. That is, the resources are not expended for the purpose of creating or producing further resources; rather, they flow largely from the imposition of taxes, a power inherent in government. Hence, in accounting for transactions in budgetary funds, we find the usage of the terms revenues and expenditures as compared with income and expense commonly used in commercial accounting.

The guide sets forth the following summary of the modifications to the accrual method of accounting for budgetary funds, i.e., the general fund, special revenue, and debt service funds:

1. Revenues are recorded as received in cash except for:
   (a) revenues susceptible to accrual, and
   (b) material revenues that are not received at the normal time of receipt.

2. Expenditures are recorded on an accrual basis except for:
   (a) disbursements for inventory type items, which may be considered expenditures at the time of purchase or at the time the items are used;
   (b) prepaid expenses, which normally are not recorded as assets;
   (c) interest on long-term debt, which should normally be an expenditure when due; and
   (d) the encumbrance method of accounting, which may be adopted as an additional modification.

It is perhaps important to repeat that the above is a summary. The interested practitioner will want to study carefully the guide's discussion on such matters as the meaning of "revenue susceptible to accrual," including alternatives for property taxes, accrual of interest in special assessment
funds and further details on encumbrance accounting, among other topics.

5. **Fixed Asset Accounting.**

Accounting for General Fixed Assets and depreciation was another topic which generated heated debates in the Committee. Essentially, the guide agrees with the NCGA in requiring accounting for General Fixed Asset Group. However, the Committee does recognize two alternative practices:

1. In the General Fixed Asset Group, certain improvements other than buildings are not required to be capitalized.

2. In applicable circumstances where depreciation is computed on General Fixed Assets, it may also be reported in that account group.

"Improvements other than buildings" referred to in the permissibility not to capitalize would be limited to roads, bridges, curbs and gutters, sidewalks, drainage systems, sewers, and lighting systems, properly a part of the General Fixed Asset Group, rather than of an enterprise fund.

The rationale for these two exceptions to GAAFR is expressed in the guide. Since the depreciation option is particularly notable, part of the rationale and conclusions is quoted as follows:

There are four reasons for computing depreciation for governmental units: (1) profit measurement for enterprise and intragovernmental service funds, (2) cost accounting for services and programs, (3) as a cost to be included in the basis for reimbursements or grants, and (4) systematic amortization of cost to recognize use or obsolescence. Granted these reasons for computing depreciation, however, maintaining such information and including it in financial statements involve separate questions.

Depreciation should be recorded on fixed assets financed primarily by charges to users, such as those included in enterprise and intragovernmental service funds. With respect to general fixed assets in a general fixed assets group of accounts, some financial statement users may prefer that depreciation be computed and reported even though such amounts are not a charge against any fund. Accordingly, as long as original cost or other appropriate amounts are maintained and reported, there is no objection to reflecting an allowance for depreciation in the general fixed assets group of accounts with a corresponding reduction in the
amount shown as the investment in such assets. Where the amount shown as the investment in such assets is categorized by source of investment, the reduction may be shown as a reduction of the total of such categories.

6. **Long-Term Liabilities**

   The Committee concurs with GAAFR's Principle No. 7 which requires a General Long-Term Debt Group of accounts for long-term general obligations. The guide's only difference with GAAFR is on certain enterprise fund bonds which are both special and general obligations. The guide's position is that if the ordinance provides for payment of recurring annual interest and principal instalments of these G. O. bonds from earnings of the enterprise fund, these bonds should be carried as a liability of the enterprise fund. The existence of the bonds should then be footnoted only in the statement of general long-term debts, rather than included also in bonds payable in that statement, as recommended in GAAFR.

7. **Financial Statements**

   With regard to financial reporting particularly, the Committee undertook to study all the accounting research bulletins, terminology bulletins, opinions, and statements published by the Institute.

   Historically, no effort has been made by the Institute to catalog or delineate which of these bulletins or opinions may be considered to apply broadly to the nonprofit field or specifically to certain types of nonprofit organizations. Appendix E of the guide on "Applicability of Professional Pronouncements to Financial Statements of Governmental Units" indicates which of the bulletins and opinions published by the Institute should be considered to apply in whole or in part to the field of governmental accounting. This sort of survey has been undertaken in no other industry audit guide and is expected
to be a very valuable aid to the independent auditor in the performance of governmental audit engagements. The Committee's conclusions are that:

1. Inasmuch as enterprise funds and intragovernmental service funds are by nature similar to commercial enterprises, all the pronouncements of the Institute should be applicable whenever the relevant economic facts are present; and

2. With regard to all other types of funds, specifically, general, special revenue, debt service, capital projects, certain trust and special assessment funds, and the general fixed assets and general long-term debt groups of accounts, some of the pronouncements are fully or partially applicable but others are inapplicable since they are directed solely at profit-making organizations.

More specifically, Appendix B addresses the topics of "adequate disclosure," comparative financial statements, reporting the results of operations, leases, pension plans, and disclosure of accounting policies, among others.

In terms of comparison with GAAFR again, the guide contains several significant modifications of reporting practices set forth in GAAFR. (Mainly, these are discussed in Chapter 6 on "Presentation of Financial Statements" or included among the eleven examples of "Illustrative Forms of Certain Financial Statements and Supplementary Schedules of Governmental Units").

Highlights of some of these reporting matters in addition to matters already covered above are as follows:

a. The use of an integrated statement of revenues, expenditures and encumbrances for the general fund is illustrated and stated to be acceptable. This statement is intended to be used in lieu of the separate statements of estimated and actual revenues and expenditures and encumbrances compared with authorizations.

b. The method of liquidating the reserve of encumbrances account and disposition of its residual balance is conformed to Accounting
Principles Board Opinion No. 9. It is recommended that the balance of the encumbrances outstanding account of the General Fund at the close of each year should be liquidated during the succeeding year by charging directly to such account the expenditures relating to the original purchase order or other commitments.

c. In reporting the results of operations, the guide applies the philosophy of APB Opinion No. 9 and APB Opinion No. 20, and recommends reporting most operating items as revenue and expenditures. It should be emphasized that this is a clear exception to the treatment of "Fund Balance Receipts" in the NCGA's text, which cites taxes and accounts receivable which had previously been written off as examples of items not properly includable in revenues. The Committee's interpretation is that these items are revenue. Another example as mentioned in b. above would be the adjustment for a difference between a prior year's reserve for encumbrances and the actual expenditure. This should be reported in the expenditure section of the operating statement. The position of the Committee is there should be relatively few adjustments to the Fund Balance account. Most transactions should be treated as revenue or as expenditures. Very rarely will events and transactions in government meet the "prior period adjustments" criteria. One example which would qualify is a change from an unacceptable accounting method.

In addition to the above modifications to the reporting practices set forth in GAAFR, the guide contains specific recommendations for appropriate reporting in a number of areas not dealt with in GAAFR.
C. Other Notable Features of the Guide

In addition to coverage on accounting principles and financial statements, the other principal notable features are sections on auditing and on the independent auditor's report.

1. Audit Concepts and Auditing Procedures

The material on auditing concepts is relatively brief because the intention was to discuss only those concepts that are unique to governmental units. Four topics are addressed:

   a. Fraud Detection.—While S.A.S. No. 1. section 110.05 certainly applies, the guide reminds its readers that there is relatively greater publicity when irregularities are discovered in government.

   b. Financial Compliance Auditing.—Assessment of financial compliance with legal requirements is obviously a required feature. Special fund requirements and budget comparisons, among others, are examples of major areas of legal requirements.

   c. Auditing for Program Compliance, Efficiency and Economy, and Program Results.—The guide calls attention to the increasing demand for information about government programs which has caused pressure for extensions of the boundaries of auditing. There is abbreviated coverage on the new United States General Accounting Office (GAO) June 1972 publication, "Standards for the Audit of Governmental Organizations, Programs, Activities, and Functions," and reference to the position paper issued by the AICPA Subcommittee on Relations with the General Accounting Office, "Auditing Standards Established by the GAO—Their Meaning and Significance for CPAs" (new York: AICPA, 1973). Aside from these references to new developments, the auditing procedures material in the guide has its focus on the financial audit.
d. Familiarization with Legal Requirements.--Legal requirements differ in terms of degree as compared with commercial audits. Familiarization with general laws and local ordinances applicable to the particular governmental unit is essential to the audit.

The material on Auditing Procedures is also addressed to unique features of governments. The following principal topics are addressed:

a. Internal Control.--This includes suggestions for preliminary planning of the audit.

b. The Audit Program.--Notably, the multi-entity feature introduced by funds is a difference.

c. Representation Letters.

d. General Audit Procedures.

e. Audit Procedures for Specific Accounts.--This also includes coverage on special audit requirements of certain funds.

2. The Independent Auditor's Report

Following are the highlights of the chapter on the independent auditor's report and the section on sample auditor's reports.

a. Responsibility for Financial Statements.--The guide makes clear that officials of the governmental unit have the responsibility for the financial statements. The independent auditor is responsible for his report on examination. The four reporting standards outlined in SAS No. 1, sections 400 and 500, are applicable to the auditor's report.

b. Auditor's Opinion.--In his report, the independent auditor should express his opinion (or disclaim an opinion) as to whether the financial statements present fairly the financial position, results of operations, and, where applicable for an enterprise fund, changes in financial position, of the various funds (or groups of related funds) and account groups.
of the governmental unit in conformity with generally accounting principles consistently applied.

The above means that separate financial statements of the funds, groups of related funds, and account groups are necessary for fair presentation in conformity with generally accepted accounting principles. The auditor's opinion is an opinion on each of the respective financial statements. Because of this, the omission of a financial statement from a financial report, even if the omission requires disclosure in the auditor's scope paragraph, should not result in any qualification in the opinion on the remaining statements. Further, circumstances leading to a qualification, disclaimer, or adverse opinion on one financial statement would not necessarily affect the auditor's opinion on other financial statements.

By way of an entirely new development the Committee, after extensive deliberation, reached the conclusion that in certain circumstances, the auditor may simplify his expression of opinion. The guide will state, in effect, that if (a) a governmental unit has established all funds and account groups the auditor believes are necessary, (b) appropriate financial statements for all funds and account groups are presented, (c) a combined balance sheet is presented, and (d) the auditor has examined all of the financial statements, the independent auditor may state simply that the financial statements present fairly the financial position and results of operations of the governmental unit. (If a statement of changes in financial position of an enterprise fund is included in the statements, an appropriate separate reference thereto is necessary.) His opinion expressed in that form is intended to have the same significance as an opinion expressed with respect to the separate financial statements of each fund (or groups of related funds) and account groups.
c. Generally Accepted Accounting Principles.--Summarizing points made above, the added expression "for governmental units" or its equivalent is considered not necessary, modified accrual basis is generally accepted for budgetary funds, and failure to report a budget would require qualifying the opinion. Generally, lack of compliance with legal requirements dealing with financial matters should be disclosed in the financial statements, usually in a note. Accordingly, no comment is necessary in the auditor's report.

d. Sample Auditor's Reports.--Twelve sample auditor's reports designed to illustrate selected situations are included in the guide.

D. Where Do We Go From Here?

In sections above, we have already called attention to a number of controversial topics. Five principal ones covered were:

Is fund accounting obsolete? Answer: No, not yet. What is the entity, the fund or the governmental unit? Answer: The fund, for now. In terms of funds, some but not all, what is a minimum report? The only brief answer is that misleading inferences must be avoided. Is reporting on legal compliance with financial requirements a matter of accounting principle? In effect: Yes.

Is the budget principle an accounting principle? In effect: Yes.

In addition, from letter responses to the exposure draft and other responses there is the fundamental question of to what extent an audit guide should be a pioneering document. Or, are generally accepted accounting principles descriptive of practice, or are they creative? The traditional answer has been that guides tend to describe best or preferred practice. They are not essentially creative. As a variation of this concern, some of our readers wanted the guide to develop an overall theory. Worthy as this may be, our answer is that at this time we were building on GAAFR.
Another question is: Does the guide actually cover state and local units, or is it primarily on local units? The answer is that it is primarily on local units. A later revision might well consider this problem. An ultimate question might be: Is a national guide helpful? One of the challenging features of our Committee work was the reconcilement of differences based on local custom or local legal requirements since Committee members were from many different states. Our premise remained that a national guide does serve an overall purpose, but we expected that individual states would address their own problems in detail. We assume that state CPA societies or other such regional bodies will write supplementary materials to address their local conditions. This process has already started in at least one state.

Finally, since accounting principles do evolve, likewise, auditing standards, it is interesting to speculate how the division of labor will proceed in the near and distant future in recording this evolution in authoritative literature. As a partial answer, it is worth noting that the NCCA is in process of being restructured and will soon be known as the National Council on Governmental Accounting. The proposed revision contemplates a new relationship between the Council and the AICPA. Subject to the acquiesence and approval of the Financial Accounting Standards Board, the Council will assume the basic responsibility for accounting principles in the field of government, leaving the function of auditing standards to the American Institute of CPAs.

The new arrangement provides for adequate representation on the National Council and its Executive Committee by practicing CPAs who are members of the Institute. Moreover, it is understood GAAFR will in due course be republished in loose leaf form and the alternative or preferred accounting principles or practices set forth in the Institute's audit guide will be incorporated in the loose leaf edition.