

## Chapter 1

# Overview and Introduction

## Scope and Purpose

**1.01** This Audit and Accounting Guide applies to all state and local governments.<sup>1,2,3</sup> Governmental organizations are subject to generally accepted accounting principles (GAAP) for state and local governments as described later in this chapter. **Public corporations<sup>4</sup> 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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<sup>1</sup> 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*.

<sup>2</sup> 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," of this guide) are within the scope of this guide. Chapter 3, "The Financial Reporting Entity," discusses GASB standards for defining and reporting component units.

<sup>3</sup> Other AICPA Audit and Accounting Guides also may be applicable to audits of certain governments. See paragraph 1.21.

<sup>4</sup> *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<sup>5</sup> is governmental or non-governmental 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.<sup>6</sup> A section of chapter 12, "Special-Purpose and State Governments," of this guide highlights the accounting, financial reporting, and auditing considerations relating to recognized Indian tribes.

**1.04** There are over 90,000<sup>7</sup> 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 Title 2 U.S. Code of Federal Regulations Part 200, *Uniform Administrative*

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<sup>5</sup> This guide uses *governmental entity* and *governmental organization* interchangeably.

<sup>6</sup> Technical Questions and Answers (Q&A) section 9160, *Other Reporting Issues*, may be relevant to audits of Indian tribes. It includes a series of Q&As that provide nonauthoritative guidance on various topics including the definition of a government, use of special purpose frameworks, and reporting on Indian tribe financial statements prepared in accordance with accounting standards as promulgated by FASB. See chapter 12, "Special-Purpose and State Governments," of this guide for further discussion.

Q&A sections are "other auditing publications." In applying the auditing guidance included in an other auditing publication, the auditor should, exercising professional judgment, assess the relevance and appropriateness of such guidance to the circumstances of the audit. Other auditing publications have no authoritative status; however, they may help the auditor understand and apply generally accepted auditing standards (GAAS). The auditor is not expected to be aware of the full body of other auditing publications. 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.

All Q&A sections can be found in *Technical Questions and Answers*.

<sup>7</sup> U.S. Census Bureau, 2012 Census of Governments.

*Requirements, Cost Principles, and Audit Requirements for Federal Awards (the Uniform Guidance)*<sup>8</sup>

- 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*,<sup>9</sup> 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 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<sup>10</sup> 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" (ET sec. 1.320.001),<sup>11</sup> 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,

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<sup>8</sup> The first three groups of audit standards and requirements are cumulative and progressive. That is, *Government Auditing Standards* incorporates and adds requirements to GAAS, and the Single Audit Act incorporates and adds requirements to both *Government Auditing Standards* and GAAS.

<sup>9</sup> All AU-C sections can be found in *AICPA Professional Standards*.

<sup>10</sup> Chapters 16, "Audit Reporting," and 17, "Financial Statements Prepared in Accordance With a Special-Purpose Framework," of this guide also discuss auditor's reports on summary financial information (popular reports) and on financial statements prepared in accordance with a special-purpose framework.

<sup>11</sup> All ET sections can be found in *AICPA Professional Standards*.

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<sup>12</sup>
- b. GASB Technical Bulletins, GASB Implementation Guides, and literature of the AICPA specifically cleared by GASB<sup>13</sup>

**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 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

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<sup>12</sup> 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.

<sup>13</sup> See paragraph 1.07 and paragraph 1.20.

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 700A, *Forming an Opinion and Reporting on Financial Statements*.) 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," of this guide.)

## 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 Position (SOPs), and Auditing Interpretations. AU-C section 935, *Compliance Audits*, 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 of this guide for a discussion about considering the requirements of AU-C section 935 while planning the audit.<sup>14</sup>

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<sup>14</sup> 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.

**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,<sup>15</sup> *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 Single Audit Act gives the director of the OMB the authority to develop government-wide guidelines and policy on performing audits to comply with the act. The OMB's Uniform Guidance establishes such audit requirements and, in addition, guidelines and policies on aspects of managing federal awards. A supporting OMB document, the OMB Compliance Supplement, which is updated annually, provides a source of information for auditors to understand the federal program's objectives, procedures, and types of compliance requirements relevant to the audit, as well as the audit objectives and suggested audit procedures for determining compliance with these requirements. 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" (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

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<sup>15</sup> 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.

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 accounting 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 of this guide 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* (ACC sec. 10),<sup>16</sup> includes governmental entities in its scope and was cleared by GASB and, thus, is category B accounting 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 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. Under AU-C section 200 these are *other auditing publications* and, although they might be useful, auditors are not required to consider them.

## 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

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<sup>16</sup> All Statements of Position can be found in AICPA *Professional Standards*.

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 position and resource flows statements,<sup>17</sup> 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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<sup>17</sup> 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 *resource flows 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 of this guide.