The Accounting and Auditing Year in Review

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Presented by

Gregory S. Allison, CPA

UNC School of Government

Overview

- ***BRIEF*** reference to the accounting/financial reporting year
  - Being dealt with extensively in GASB-related sessions
- Highlights of new guidance in the 2013 *Comprehensive Implementation Guide*
- Overview of the Clarified Audit Standards project and highlights of the specific requirements
- 2011 Yellow Book Revisions

Accounting in Review

- GASB Statement No. 65, *Items Previously Reported as Assets and Liabilities*
  - Concept of net position
  - Deferred outflow of resources
  - Deferred inflow of resources
  - Required for fiscal periods beginning after 12/15/12
- Much more detail being presented in other GASB-related sessions

Accounting in Review (cont.)

- GASB Statement No. 69, *Government Combinations and Disposals of Government Operations*
  - Required for fiscal periods beginning after 12/15/13
- GASB Statement No. 70, *Accounting and Financial Reporting for Nonexchange Financial Guarantees*
  - Required for fiscal periods beginning after June 15, 2013

2013-2014
Comprehensive Implementation
Guide

Basics About the CIG

- Updated through June 30, 2013

- Overall, 15 new questions have been added
  - NOT including questions related to the incorporation of the new implementation guide for GASB Statement No. 67, *Financial Reporting for Pension Plans*

- Many questions amended to incorporate recent statements

4.11.6 – Tax Levy Authority

Scenario

- Charter school cannot levy taxes
- Funding formula includes allocation of portion of sponsoring school district’s tax levy

Question

- Is the levy allocation equivalent to the sponsoring government effectively approving their levy for fiscal dependency purposes?

4.11.6 (cont.)

Answer

- No – since the Charter School does not have levying power to begin with, this does not create an implicit ability to do so. There is obviously a financial burden, but not fiscal dependency. Dependency would be evidenced by the Charter only being able to levy with approval.

4.30.9 - Blending

Scenario

- State government creates financing authority to issue debt for itself and local schools (25%)
- State has pledged to repay ALL the debt (even that portion related to the school financing)

Question

- How should the financing authority be reported in the State's financial statements?

4.30.9 (cont.)

Answer

- Financing authority should be blended because
  - the Authority's debt is going to be repaid "entirely, or almost entirely" by the State.

This criteria was added to the list of blending requirements with GASB Statement No. 61, "The Financial Reporting Entity: Omnibus".

4.30.10 - Blending

Scenario

- Assume, in the previous example, that the debt attributable to the Schools was to be repaid with a tax levy and not by the State

Question

- Would this change how the financing authority would be reported?

4.30.10 (cont.)

Answer

- Since the 25% portion attributable to the Schools would be considered a substantial portion of the overall debt, the State would NOT be expected to repay the debt “entirely, or almost entirely”. Therefore, assuming the other facts remain the same, the financing authority would be discretely presented.

7.23.16 – Net Investment in Capital Assets

Scenario

- An entity has several enterprise funds, one of which is a financing authority and is a blended component unit of the primary government
- Authority issues debt and loans proceeds to other enterprise fund, which purchases capital

Question

- Who has the capital-related debt?

7.23.16 (cont.)

Answer

- The enterprise fund that borrowed the funds carries the capital assets and reports an interfund loan.
- The authority reports the debt and an interfund receivable.
- The fact that the loan is to a separate legal entity (albeit blended component unit) is critical.
- The enterprise fund has “capital-related” debt, not the financing authority.

10.15.9 – Termination of Hedge Accounting

<u>Scenario</u>

- An interest-rate swap with an original fixed rate of 5% is re-negotiated at a later date to a rate of 3%
- Hedges are considered terminated if any critical terms are changed.

<u>Question</u>

- In this case, has the hedge terminated and, if so, what are the ramifications?

10.15.9 (cont.)

Answer

- The rate of interest is definitely a “critical term” in an interest-rate swap hedging arrangement. Therefore, the hedge is terminated and the previously deferred amount would be recognized as income (in this case) for the period.

10.16.6 – Hedging Derivative Instruments

Scenario

- An interest-rate swap is used to hedge mortgage-backed bonds. The contract contains a call option that allows the issuing entity to adjust the notional amount, as needed. They do so for prepayments.

Question

- Is this an action that terminates the hedge?

10.16.6 (cont.)

<u>Answer</u>

- No. The option itself (thus the ability to exercise it) was part of the original agreement. Therefore, it is not considered a “critical term” in the agreement that has been breached.

Z.54.63 – Fund Balance Classification

Scenario

- Governing body sets aside a portion of fund balance for the specific purpose of paying for appropriated expenditures at the beginning of the new fiscal year; this portion of fund balance "cannot be used for any other purpose"

Question

- Should this portion of fund balance be considered "committed" fund balance?

Z.54.63 (cont.)

Answer

- The amount set aside can be used for any purpose – it is mainly a timing restriction. Thus, the limitation is not *how* the resources can be spent, but *when*. This is more of a minimum fund balance policy – it is not a true commitment. The action is irrelevant for classification – it would be part of unassigned fund balance.

Z.60.1 – Service Concessions

Scenario

- A service concession arrangement (SCA) is evidenced by the government remaining in control of the type and level services to be provided, as well as to whom. This is typically explicit in the contract.

Question

- Is it possible to have an SCA that does not explicit identify this in the contract?

Z.60.1 (cont.)

Answer

- Yes – control is often assured even in the absence of specific language use in the contract. For example, the purpose and intent of golf courses, toll roads, etc. are sufficiently clear.

Z.63.1 – Deferred Outflows/Inflows

Scenario

- Assume that a deferred outflow arose from an effective hedging arrangement, as did a deferred inflow from a similar arrangement.

Question

- Can these deferred outflows and inflows be netted?

Z.63.1 (cont.)

Answer

- No – assets and liabilities may not be netted unless there is "right of legal offset". The same principle applies to deferred outflows and deferred inflows.

Z.69.1 – Government Combinations

<u>Scenario</u>

- A government dissolves and ceases to exist.
- All of its operations form the basis of a new governmental entity
- No consideration is exchanged in the event.

<u>Question</u>

- Is this a government combination (i.e., merger or acquisition) or a transfer of operations?

Z.69.1 – Government Combinations

Answer

- A merger or acquisition requires there be two legal entities entering into the combination, so it does *not* qualify.
- The dissolution of a *single* entity that allows the creation of a new legal entity is simply a transfer of operations. There is no requirement for the *original single* entity to continue to exist.

Clarified Auditing Standards

- New GAAS intended to make standards easier to comprehend
- Achieves more uniformity with International Standards of Auditing
- Often referred to as the “Clarity Standards”

Basic Information

- Complete set of revised standards found in Statement of Auditing Standards (SAS) No. 122, *Statement of Auditing Standards: Clarification and Recodification*
  - Supersedes standards through SAS No. 116 and No. 121 (Nos. 117 and 120 were issued in the new clarity format)

Standardized Format

- Introduction – *describes standard in an overview manner*
- Objectives – *provides overall goal, purpose, framework, context, and application*
- Definitions – *glossary of terms contained within the standard*

Standardized Format (cont.)

- Requirements – *contains the standard*
  - Unconditional requirements (indicated by the word “must”)
  - Presumptively mandatory (indicated by the word “should”)
- Application – *explanatory material*
  - Uses the word “may” when providing examples
  - Includes special considerations for audits of governmental entities

Referencing

- Standards use “AU-C” section numbers instead of “AU”
  - Temporary referencing system to avoid confusion of clarified and yet-to-be clarified standards used through 2013
  - Standards will revert back to “AU” referencing in 2014 when the clarity project is completed
- Most of the clarity standards include guidance specifically for governmental audits

Independent Auditor’s Report

- Format of report significantly changed
  - Includes paragraph headings such as…
    - Management’s responsibility of the financial statements
    - Auditor’s responsibility
    - Opinion
  - Specific language required in the report

Independent Auditor's Report (cont.)

- Required explanation regarding management's financial statement responsibilities
  - Presented in accordance with applicable reporting framework
  - Design, implementation, and maintenance of internal controls
  - Statements are free from material misstatements

Independent Auditor’s Report (cont.)

- Reports are no longer referred to as “unqualified” or “qualified”
  - Replaced with “unmodified” or “modified”
- Items previously reported in an explanatory paragraph (e.g., litigation uncertainty, subsequent events, going concern) should now be in an *“Emphasis of Matter and Other Matter”* paragraph (includes auditor’s responsibilities for RSI and other supplementary info)

Modification to Engagement Letters

- “Terms of engagement” require the auditor to assess on returning engagements if circumstances warrant audit terms to be revised

- If not, the management letter should address that fact

Audit of Opening Balances

- Initial and re-audit engagements require the auditor to obtain appropriate audit evidence related to opening balances
  - Potential misstatements?
  - Are policies reflected in the opening balances consistent with the current period's reporting
- Reviewing a predecessor's audit reports is not enough to obtain sufficient audit evidence

Audits of Group Financial Statements

- Guidance where work part of the audit work is performed by auditors with another firm, a network firm, or an audit team's "other" location
- Clarity standards widen the scope of existing guidance
- Should be noted that the definition of "component" by AICPA is not necessarily consistent with GASB
- Generally, primary government's auditor responsibilities have expanded

New/Expanded Terminology

- Structure contained in the general, field work, and reporting standards have changed
  - Financial reporting framework
  - Applicable financial reporting framework
  - Fair-presentation framework
  - Regulatory and contractually-based framework

Other Items of Note

- Auditors are now required to inspect correspondences, if any, with relevant licensing or regulatory authorities
- Standards specifically require the auditor to communicate *only to management* (in writing or verbally) any deficiencies in internal controls that merits their attention (historically implicitly by practice in the management letters)

Other Items of Note (cont.)

- Auditors required to communicate *in writing* to management/those charged with governance an explanation of the effects of significant deficiencies or material weaknesses
- Auditors required to send an attorney's letter only if they believe actual or potential claims may risk material misstatement; deciding it is not necessary should be documented

Other Items of Note (cont.)

- Explicit requirement for auditors to obtain sufficient understanding of related-party relationships/transactions
  - Specific requirement to discuss during the engagement team discussion
  - Identified relationships outside the normal course of business as significant risks

2011 Yellow Book Revisions

- *Government Auditing Standards* (GAGAS) 2011 Revision have been issued. Effective for years ending on or after December 15, 2012.
- Revised Yellow Book reports are required.
- Significant changes in the area of auditor's independence.
- The 2011 Yellow Book uses a conceptual framework for determining independence.

Applying the Conceptual Framework

- There are three steps to the conceptual framework approach:
    1. Identify threats to independence
    2. Evaluate the significance of the threats identified, both individually and in the aggregate
    3. Apply safeguards as necessary to eliminate the threats or reduce them to an acceptable level

Threats to Independence

- Self-interest threat – influenced due to a financial or other interest
- Self-review – an auditor will be reviewing his or her own work.
- Bias – based on political, social, ideological or other convictions
- Familiarity – due to relationships with personnel of the entity
- Undue influence – pressures may influence the auditor’s judgment.
- Management participation – auditor will be taking on the role of management.

Applying Safeguards to Threats

- Auditor must apply safeguards to eliminate those threats or reduce them to an acceptable level. Examples of safeguards:
  - Consulting a knowledgeable third party,
  - Involving another firm to perform part of the audit,
  - Having another staff member, not on the audit team, review the work, or
  - Removing the individual who poses a threat to independence from the audit team.

Financial Statement Preparation and Bookkeeping

- Activities such as financial statement preparation, conversions from the cash basis to the accrual basis of accounting for reporting purposes, and reconciliations are not prohibited.
- However, each service would have to be evaluated using the conceptual framework.

Proposed Changes to Federal Single Audits

- Single Audit Threshold for Audit Proposed to Increase to $750,000.
- Changes to the Major Program Determination Process – Type A/B Threshold (minimum of $500,000)
- Changes to percentage coverage of federal expenditures required for testing from 50% to 40% for regular auditees (25% to 20% for low-risk auditees).

Proposed Changes to Federal Single Audits (cont.)

- Changes to the requirements for low-risk auditee.
- Changes to the Major Program Determination Process –High Risk Type A Programs and Type B Programs
- Reduction in Type of Compliance Requirements to be Tested (from 14 to 6)
- Reform to cost principles (consolidations).

Proposed Changes to Federal Single Audits (cont.)

- Other proposed changes:
  - Questioned costs threshold increases to \$25,000 from \$10,000;
  - Indirect cost changes, consolidation, uniform set of administrative requirements, guidance to ensure robust oversight of sub-recipients.