



LOCAL GOVERNMENT DIVISION

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Questions or Concerns?

If any entity has questions or concerns regarding budgeting, financial reporting, or compliance with state law or policy, please feel free to call any of the individuals listed above. If we don't have the answer, we can research the question or refer you to the office or individual that can help you! Outside the Salt Lake City area, feel free to use our toll-free telephone number: 1-800-622-1243. You can also e-mail us at the addresses shown above.

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AUDIT COMMITTEES

Does your local government have a functioning audit committee? Does your CPA inform your audit committee about matters required by government auditing standards?

If your local government does not have an official audit committee, by default the board, city council, or county commissioner becomes this committee. Every local government should not only establish a formal audit committee, but also make sure the audit committee works properly. A properly designed audit committee promotes independence; facilitates communication between management, the auditors, and governing boards; and helps the government manage the audit.

Since by default every local government has some sort of audit committee, what can local governments do to make their audit committee more effective and efficient? The Government Finance Officers Association (GFOA) has developed the following recommendations regarding local government audit committees.

1. Every government should establish an audit committee or its equivalent. Reliable audits are essential to the credibility of financial reporting by local governments. The audit committee is a practical tool that a government can use to enhance the independence of the external auditor, and hence the reliability of the financial statement audit.
2. The audit committee should be formally established by charter, enabling resolution, or other appropriate legal means.
3. The members of the audit committee collectively should possess the expertise and experience in accounting, auditing, financial reporting, and finance needed to understand and resolve issues raised by the independent auditor.
4. A majority of the members of the audit committee should be selected from outside of management. At the same time, the audit committee should include at least one representative from the government.
5. An audit committee should be sufficiently large to ensure that its member possess all of the skills needed to realize the committee's objectives. At the same time, the audit committee should be small enough to operate efficiently. Therefore, as a general rule, an audit committee should be composed of no less than five and no more than seven members.
6. Members of the audit committee should be educated regarding both the role of the audit committee of the government's financial statements, from the selection of the independent auditor to the resolution of audit findings.

7. The audit committee should have access to the reports of any internal auditors, as well as access to any annual internal audit work plans.
8. The audit committee should present annually to the governing board and management a written report of how it has discharged its duties and met its responsibilities. It is further recommended that this report be made public.

Consider these recommendations from GFOA. An audit committee that functions as prescribed above will only help the financial reporting of a local government.

City or Town?

Some of the very small cities have contacted the State Auditor's Office and inquired as to the possibility of reverting back to town status since they currently meet the population requirements of being a town. These questions, I'm sure, were posed because of HB 244 passed earlier this year. With the passage of HB 244, the Utah Legislature realigned some of the population requirements and created two new classes of cities. . . .fourth class and fifth class cities. The new breakdown goes as follows: a municipality with population of 100,000 or more is a first class city; a municipality with population of 65,000 but less than 100,000 is a second class city; a municipality with population 30,000 or more but less than 65,000 is a third class city. The two new classes include a municipality with a population of 10,000 or more but less than 30,000 which is a city of the fourth class. A municipality with a population of 1,000 or more but less than 10,000 is a city of the fifth class. Finally, a municipality with a population under 1,000 is a Town.

By way of review, in the year 2000, a town was defined as a municipality with population under 800. This was also the year that the Lt. Governor Office was given the specific responsibility to instigate changes in class and provide certificates of classification to the municipalities affected.

In 2001, the definition of a town was changed to mean any municipality with population under 1,000. By making this change, some of the cities that had moved from town to third class city status the previous year, would be eligible to revert back to town the following year. The Lt. Governor's office did not do this because there was a possibility that some of the new cities wanted to remain a third class city.

At this point, however, if there are any Fifth Class Cities with populations under 1000, that would

prefer to revert to town status, it could be handled very quickly and easily by the Lt. Governor if the municipality will inform that office of their intent.

Fund Definitions – Enterprise Fund

Minor changes have been made to the definition of certain funds as a result of GASB 34. For example, GASB 1300.109 now defines activities that are required to be reported as an enterprise fund. The word required was not used in GASB's previous definition of an enterprise fund.

The definition of the enterprise fund is generally the same as before with what appears to be added clarification for certain types of situations. For example, the new definition first recommends that you apply the criteria for evaluating an enterprise fund based upon the "...activity's principle revenue sources." Insignificant activities that do not support the overall activity are not required to be reported as a separate enterprise fund. GASB uses the example of a court that assess plaintiffs a fee to cover the costs frivolous claims. The court is supported by taxes and the fees collected for frivolous claims are insignificant to operating the court; therefore, an enterprise fund would not be set up for fees collected for frivolous claims.

The criteria used to define an enterprise fund that is essentially the same as the previous definition is any activity where a law, regulation or pricing policy is established to recover the cost (including depreciation and debt service) of providing the activity or service. The new criterion also includes activities that are "...financed with debt that is secured solely by a pledge of the net revenues from fees and charges of the activity." Debt that is guaranteed by revenues, fees or the full faith and credit of the related primary government or component unit do not meet the criteria of an enterprise fund. [GASB 1300.109]

GASB 34 has also created a permanent fund which, "...should be used to report resources that are legally 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." [GASB 1300.108]

GASB uses the example of a cemetery perpetual care fund as a permanent fund. These funds restrict earnings and provide resources for the ongoing maintenance of a cemetery.

In light of changes to fund definitions it would be a good idea to look at all funds and make sure they meet the current definition of the fund.

Change in Single Audit Threshold

The Office of Management and Budget (OMB) has revised Circular A-133 increasing the amount of federal expenditures which require a single audit from \$300,000 to \$500,000. Although, the threshold for a single audit has been increased the threshold for distinguishing between Type A and Type B programs remains at the base threshold of \$300,000. This change is effective for audit periods ending after December 31, 2003.

Yellow Book Independence

As we have reviewed CPA working papers of local government audits we have found that a topic of frequent discussion is Yellow Book independence standards specifically in relation to the amount of assistance the auditor can provide in the preparation of financial statements. This is an issue we have had to consider in our office as well.

The new independence standards are effective for financial audits and attestation engagements of periods ending on or after January 1, 2004.

Yellow book standards identify two overarching principles that should be kept in mind when considering whether nonaudit services will impair independence. The overarching principles are essentially first, the auditor should not make management decisions and second, auditors should not audit their own work.

New independence standards also require the auditor to, "...avoid situations that could lead reasonable third parties with knowledge of the relevant facts and circumstances to conclude that the auditor is not able to maintain independence in conducting audits." If the auditor determines that the nonaudit services will not impair their independence the auditor must then apply all

safeguards outlined in paragraph 3.25.

Yellow Book provides specific guidance relating to the amount of assistance the auditor may provide to the client in preparing the trial balance, draft financial statements and notes. The following has been summarized from Yellow Book paragraph 3.26 and Q&A #46:

- a. An auditor may prepare draft financial statements as long as they are based on management's chart of accounts and trial balance. Any adjusting or closing entries to the trial balance must be understood and approved by management.
- b. An auditor may prepare draft notes as long as they are based upon information determined and approved by management.
- c. A trial balance may be prepared based upon management's chart of accounts and appropriate books and records that balance.
- d. Depreciation schedules may be maintained by the auditor as long as management determines the method, rate and salvage value used in the calculation. However, the auditor may not maintain basic accounting records or take responsibility for financial records that they will later audit.
- e. The auditor may not post transactions to the client's financial records. However, the auditor may propose entries that the client understands, approves and posts.

The management representation letter should acknowledge the auditor's role in the preparation of the trial balance, draft financial statements and notes. Also, the representation letter should indicate that management has reviewed, approved and takes responsibility for information the auditor has assisted with.

Essentially, the auditor's involvement may only be technical in nature and not involve management decisions or the maintenance and preparation of underlying financial records that initiate or support a transaction. Also, management must have sufficient knowledge to evaluate, approve and understand the trial balance, draft financial

statements and notes in order to take responsibility for them.

Infrastructure – Modified Approach

The modified approach is an alternative to depreciation for the reporting of inexhaustible or infrastructure assets. GASB 1400.103 defines infrastructure assets as follows:

“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 include 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 should not be considered infrastructure assets.”

The modified approach may be applied to eligible infrastructure assets. Eligible infrastructure assets are those that compose either a network or a subsystem. Therefore, if used, the modified approach should be applied to all assets within the selected network or subsystem. A network is composed of all assets that provide a particular type of service for a government. A subsystem is composed of all assets that make up a portion or segment of a network. For example, a water distribution system of a government could be considered a network. Pumping stations, storage facilities, and distribution mains could be considered subsystems of that network.

In order to use the modified approach, eligible infrastructure assets must meet two requirements. First, the assets should be managed using an asset management system that meets the required criteria. Second, the government should document that the assets are being preserved at or above a condition level established by the government. The condition level should be established and documented by administrative or executive policy, or by legislative action.

The following is required criteria for an asset management system:

- a. Have an up-to-date inventory of eligible infrastructure assets
- b. Perform condition assessments of the eligible infrastructure assets and summarize the results using a measurement scale
- c. Estimate each year the annual amount to maintain and preserve the eligible infrastructure assets at the condition level established and disclosed by the government.

Condition assessments should be documented in such a manner that they can be replicated. Replicable condition assessments are those that are based on sufficiently understandable and complete measurement methods such that different measurers using the same methods would reach substantially similar results.

Condition assessments may be performed using statistical samples that are representative of the eligible infrastructure assets being preserved. Governments may choose to assess their eligible infrastructure assets on cyclical bases. For example, one-third may be assessed each year. If a cyclical basis is used, a condition assessment is considered complete for a network or subsystem only when condition assessments have been performed for all (or statistical samples of) eligible infrastructure assets in that network or subsystem.

If the modified approach is used, then all expenditures that preserve the useful life of the assets should be expensed. Disbursements that increase the capacity or efficiency of the assets should be capitalized.

There are required disclosures when using the modified approach. The disclosures are presented as required supplementary information and include information such as the assessed condition, the estimated annual amount of expenditures required to maintain or preserve the assets at the established condition level, the basis for the condition measurement and the condition level the government intends to maintain the assets. (see GASB 1400.118-119)