

Section 9160, *Other Reporting Issues*



31. Following Accounting Standards as Promulgated by FASB by a State or Local Governmental Entity

Background

The “Accounting Principles Rule” (AICPA, *Professional Standards*, ET sec. 1.320.001) of the AICPA Code of Professional Conduct states, in part, the following:

A member shall not (1) express an opinion or state affirmatively that the financial statements or other financial data of any entity are presented in conformity with generally accepted accounting principles or (2) state that he or she is not aware of any material modifications that should be made to such statements or data in order for them to be in conformity with generally accepted accounting principles, if such statements or data contain any departure from an accounting principle promulgated by bodies designated by Council to establish such principles.

The “Council Resolution Designating Bodies to Promulgate Technical Standards” (AICPA, *Professional Standards*, ET app. A) of the AICPA Code of Professional Conduct sets forth four accounting standard setters that have been designated by the Council of the AICPA. They are the Financial Accounting Standards Board (FASB), the Governmental Accounting Standards Board (GASB), the Federal Accounting Standards Advisory Board (FASAB), and the International Accounting Standards Board (IASB). Therefore, pursuant to the “Accounting Principles Rule,” an entity that meets the definition of a state or local government and purports to prepare its financial statements in accordance with generally accepted accounting principles (GAAP) should follow GAAP as promulgated by GASB.

Inquiry—How should an auditor determine whether an entity (or component thereof, such as a component unit) is a state or local government for purposes of determining whether the entity is following the appropriate accounting standards?

Reply—The auditor should evaluate the entity against the definition of a state or local government as found in several AICPA Audit and Accounting Guides (for example, *State and Local Governments*, *Not-for-Profit Entities*, and *Health Care Entities*). That definition has been cleared by GASB and, therefore, according to GASB Statement No. 76, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*, is considered to be category (b) GAAP. As a result, an entity that meets the definition should follow accounting standards as promulgated by GASB to prepare its financial statements.

Entities are governmental or nongovernmental for accounting, financial reporting, and auditing purposes based solely on the application of the definition of a state or local government. Other factors are not determinative. For example, the fact that an entity is incorporated as a not-for-profit entity and exempt from federal income taxation under the provisions of IRC Section 501 is not a criterion in determining whether an entity is governmental or nongovernmental for accounting, financial reporting, and auditing purposes.

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.32 Reporting on Accounting Standards as Promulgated by FASB by a State or Local Government

Inquiry—An entity (or a component thereof, such as a component unit) that meets the definition of a state or local government prepares its financial statements in accordance with accounting standards as promulgated by FASB. How should an auditor report on such financial statements?

Reply—The auditor should evaluate whether the financial statements are prepared, in all material respects, in accordance with the requirements of the appropriate accounting standard setter. Because the appropriate accounting standards would be those as promulgated by GASB (not accounting standards as promulgated by FASB), the auditor should evaluate whether the financial statements are materially misstated from the appropriate GAAP (in this case accounting standards as promulgated by GASB). This evaluation would encompass the application of specific accounting principles as well as the form and content of the financial statement presentation. If the auditor concludes, based on the audit evidence obtained, that the financial statements as a whole are materially misstated from accounting standards as promulgated by GASB, the auditor should modify the opinion in the auditor’s report, in accordance with AU-C section 705, *Modifications to the Opinion in the Independent Auditor’s Report* (AICPA, *Professional Standards*).

[Issue Date: July 2017.]

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.33 Engagement Acceptance When a State or Local Government Elects to Follow a Special Purpose Framework

Inquiry—An entity (or a component thereof) that meets the definition of a state or local government elects to prepare its financial statements in accordance with a special purpose framework (SPF). What are the auditor’s responsibilities concerning the acceptability of the SPF used by management?

Reply—As a precondition of an audit, AU-C section 210, *Terms of Engagement* (AICPA, *Professional Standards*), requires the auditor to establish whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable. Factors that are relevant to the auditor’s determination of the acceptability of the financial reporting framework to be applied in the preparation of the financial statements include the following:

- The nature of the entity (for example, whether it is a business enterprise, a governmental entity, or a not-for-profit organization)
- The purpose of the financial statements (for example, whether they are prepared to meet the common financial information needs of a wide range of users)
- The nature of the financial statements (for example, whether the financial statements are a complete set of financial statements or a single financial statement)
- Whether law or regulation prescribes the applicable financial reporting framework

If the auditor determines that the SPF is not acceptable in this circumstance, the auditor should not accept the engagement.

[Issue Date: July 2017.]

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.34 Accounting Standards as Promulgated by FASB as a Special Purpose Framework

Inquiry—An entity (or a component thereof) that meets the definition of a state or local government elects to prepare its financial statements in accordance with accounting standards as promulgated by FASB. Because the appropriate accounting standards are those promulgated by GASB, can the accounting standards as promulgated by FASB be considered a special purpose framework?

Reply—No. AU-C section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks* (AICPA, *Professional Standards*), defines a *special purpose framework* as

A financial reporting framework other than GAAP that is one of the following bases of accounting:

- a.* **Cash basis.** A basis of accounting that the entity uses to record cash receipts and disbursements and modifications of the cash basis having substantial support (for example, recording depreciation on fixed assets).
- b.* **Tax basis.** A basis of accounting that the entity uses to file its tax return for the period covered by the financial statements.
- c.* **Regulatory basis.** A basis of accounting that the entity uses to comply with the requirements or financial reporting provisions of a regulatory agency to whose jurisdiction the entity is subject (for example, a basis of accounting that insurance companies use pursuant to the accounting practices prescribed or permitted by a state insurance commission).
- d.* **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.

- e. **Other basis.** A basis of accounting that uses a definite set of logical, reasonable criteria that is applied to all material items appearing in financial statements.

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.35 Reporting on Indian Tribe Financial Statements Prepared in Accordance With Accounting Standards as Promulgated by FASB

Inquiry—An Indian tribe (or a component thereof, such as a business component functioning like a commercial entity) that meets the GAAP definition of a state or local government prepares its financial statements in accordance with accounting standards as promulgated by FASB. In such situations, may an auditor report on whether the entity’s financial statements are presented, in all material respects, in accordance with both the appropriate GAAP framework (that is, accounting standards as promulgated by GASB) and accounting standards as promulgated by FASB?

Reply—Generally accepted auditing standards do not prohibit an auditor from issuing a report containing two opinions—one opinion on whether the financial statements are presented fairly, in all material respects, in accordance with the appropriate GAAP, and a second opinion on whether the financial statements are presented fairly, in all material respects, in accordance with the accounting standards as promulgated by FASB. An illustrative report that an auditor may issue on a tribe’s financial statements when the entity has prepared its financial statements in accordance with accounting standards as promulgated by FASB follows:

Report on the Financial Statements

We have audited the accompanying financial statements of XYZ Entity, which comprise the balance sheet as of December 31, 20X1, and the related statements of income, changes in stockholders’ equity, and cash flows 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 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 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.

Basis for Adverse Opinion on U.S. Generally Accepted Accounting Principles for Governmental Entities

As described in Note X of the financial statements, XYZ Entity is a governmental entity as defined by the Governmental Accounting Standards Board (GASB). Accordingly, the standards as promulgated by GASB are the appropriate accounting standards for XYZ Entity to follow. However, XYZ Entity has prepared its financial statements in accordance with accounting standards as promulgated by the Financial Accounting Standards Board (FASB) even though the entity meets the "governmental" criteria.

The effects on the financial statements of the variances between the accounting policies described in Note X and generally accepted accounting principles for governmental entities, although not reasonably determinable, are presumed to be material.

Adverse Opinion on U.S. Generally Accepted Accounting Principles for Governmental Entities

In our opinion, because of the significance of the matter discussed in the "Basis for Adverse Opinion on U.S. Generally Accepted Accounting Principles for Governmental Entities," the financial statements referred to above do not present fairly, in accordance with accounting principles generally accepted in the United States of America for governmental entities, the financial position of XYZ Entity as of December 31, 20X1, or changes in financial position or cash flows thereof for the year then ended.

Opinion on Accounting Standards as Promulgated by the Financial Accounting Standards Board

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Entity as of December 31, 20X1, and the results of its operations and its

cash flows for the year then ended in accordance with accounting standards as promulgated by FASB.

[Auditor's signature]

[Auditor's city and state]

[Date of the auditor's report]

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