

# ***Environmental Protection Agency Clean Water State Revolving Fund***

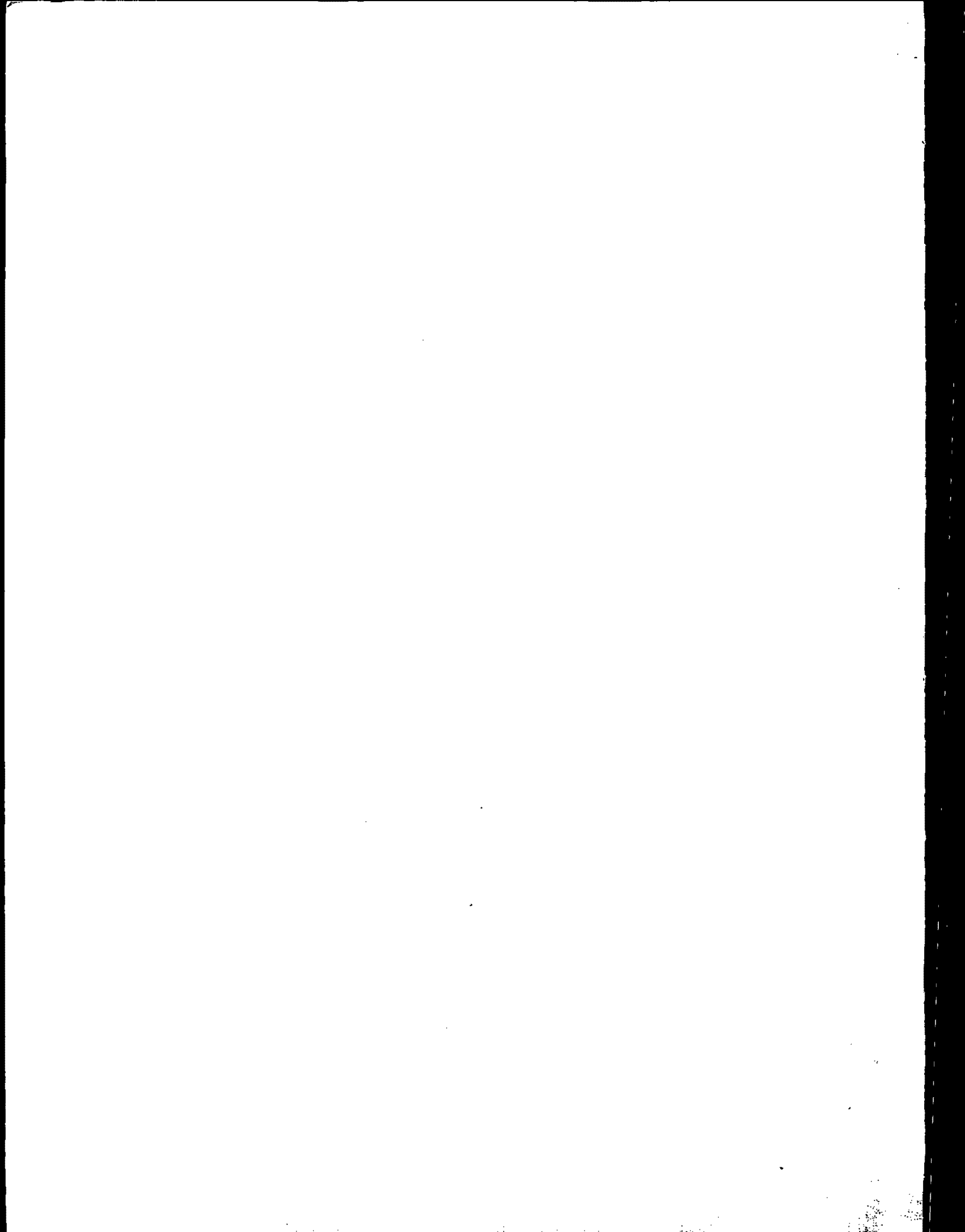
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## ***Audit Guide***



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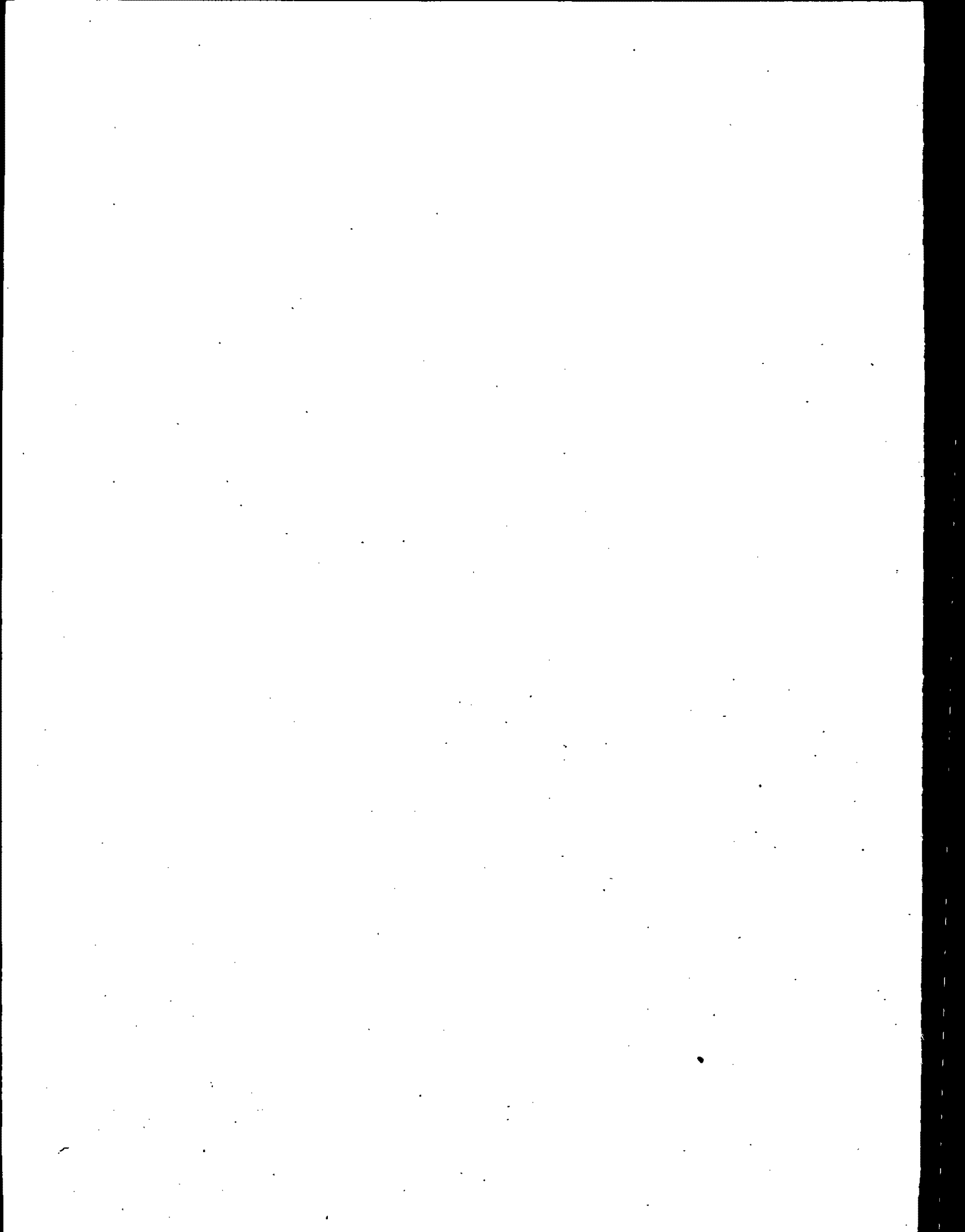
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# **CHAPTER 1 - PURPOSE AND OBJECTIVES**

## **PURPOSE**

The purpose of this document is to provide guidance in performing financial audits of the Clean Water State Revolving Funds (SRF) administered by states. This guide is for the use of Environmental Protection Agency (EPA), Office of Inspector General (OIG) auditors. The OIG encourages state auditors and Independent Public Accountants to use this guide when performing SRF financial audits.

The guide is not intended to be a complete manual of procedures, nor is it an audit program. The guide incorporates relevant auditing standards, including General Accounting Office (GAO) guidance where applicable, and outlines key issues to be considered in SRF programs. However, it is not a substitute for the existing regulations nor does it eliminate the need to review current GAO and EPA regulations, state laws, and pronouncements issued by the Financial Accounting Standards Board (FASB) or the Governmental Accounting Standards Board (GASB). Auditors are expected to exercise professional judgment in performing SRF financial audits.

The guide was prepared on the assumption that the auditor will have to perform an audit to accomplish the objectives presented below. However, the auditor may often determine that work performed by others (EPA annual reviews, other SRF audits, and Office of Management and Budget [OMB] Circular A-133 audits) may be useful in meeting the objectives. Audit procedures should assure that auditors build on the work of others so that there is no duplication of audit effort. Accordingly, while relying on the work of others, the auditor should exercise judgement whether to perform additional work in each of the objectives. In such cases, consultation with the OIG is encouraged.

## **AUDIT OBJECTIVES**

Audits of the SRFs administered by states will normally have the following objectives:

- To determine whether the SRF financial statements are presented fairly in all material respects in conformity with Generally Accepted Accounting Principles (GAAP).
- To obtain an understanding of internal controls over SRF funds sufficient to plan the audit to support a low assessed level of control risk for the SRF.
- To determine whether the state has complied in all material respects with laws, regulations, and the provisions of SRF capitalization grants.

The product of the audit is expected to include the following:

- Financial statements with an opinion (or disclaimer of opinion) as to whether the SRF financial statements are presented fairly in all material respects in conformity with GAAP.
- A report on internal controls related to the SRF financial statements. The report should describe the scope of testing of internal controls and the results of tests, and where applicable, refer to a separate schedule of findings and/or costs questioned.
- A report on compliance that includes an opinion (see Chapter 7 - Audit Completion and the Auditor's Report) as to whether the state has complied in all material respects with laws, regulations, and the provisions of the SRF capitalization grants.

## **REFERENCE MATERIAL**

In planning and conducting financial audits of state SRF's, and reporting the results, access to and review of certain reference material is important. Reference material is identified in Appendix B.

## **CHAPTER 2 - BACKGROUND**

### **STATUTORY AND REGULATORY AUTHORITY**

Title VI of the Clean Water Act of 1987 (the Act) established the SRF program (CFDA No. 66.458) to replace the wastewater treatment facilities construction grants program. The SRF program is established in each state by capitalization grants awarded by EPA. The **audit focus** is on a state's SRF program, rather than individual capitalization grants awarded to states by EPA.

The expectation of the SRF program is to create **permanent** revolving funds in each state that will provide funds for the state to make **loans** to local governments to construct needed wastewater treatment facilities. It can also be used for other types of projects such as:

- Implementing nonpoint source pollution control management programs under section 319; and
- Developing and implementing estuary conservation and management plans according to section 320.

In addition to loans, the SRF can provide the following types of other assistance:

- Refinance existing debt for obligations incurred prior to March 7, 1985 for constructing wastewater treatment facilities.
- Guarantee or purchase insurance for local debt obligations, where such insurance would improve credit access or lower interest rates.
- Serve as a source of revenue or security for the payments on revenue or general obligation bonds if the bond proceeds are deposited to the SRF. When the SRF is used to provide security or guarantees of debt obligations, the process is known as leveraging. Leveraging increases the funds available for loans in the early years by using the SRF to offset interest paid on bonds, and provide a reserve in case of default by the state or local community.
- Provide loan guarantees for similar revolving funds established by municipalities or agencies.
- Earn interest on fund accounts, such as loan repayments or a reserve account used to secure proceeds from a tax-exempt bond issue.

- Pay the reasonable costs of administering the SRF, provided that the amount does not exceed 4 percent of all grant awards.

Uses of the SRF are more fully discussed in the Code of Federal Regulations (CFR), Part 40, Subpart K. The regulations identify the exact types of assistance that the SRF can provide, and additional requirements, limitations, and procedures for establishing and operating the SRF.

EPA implements the SRF program in a manner that preserves a high degree of flexibility for states in operating their revolving funds in accordance with each state's unique needs and circumstances.

## FUNDING THE SRF

EPA's capitalization grants provide the initial SRF financing. The grants require that the states provide a 20 percent match. The state match can be made by a number of methods, such as direct appropriation, general obligation bonds, revenue bonds, or other methods. Through June 30, 1997, capitalization grant awards were \$13.2 billion with state matching of \$2.7 billion.

When a state receives a capitalization grant, it agrees to a "payment schedule" with EPA. The "payment schedule" does not represent actual payments, but are authorized increases to the amount a state can draw from EPA through the Automated Clearing House (ACH). The payment schedule identifies the dates that the funds will be available to the state. The state generally has one year after the payment to obligate the funds, which is known as making "binding commitments". The binding commitments must equal at least 120 percent of the payments received one year earlier, which accounts for both the federal and state shares of the SRF.

Cash draws on the SRF are typically made when a state is presented with reimbursement requests from the loan recipients. In a direct loan program, the state will draw 83.33<sup>1</sup> percent of the requested amount from EPA, transfer the state share to the SRF (16.67 percent), and then issue the reimbursement to the communities involved. How funds are drawn, and the amounts drawn, will vary for leveraged programs, depending on the exact method used, but the EPA share will be 83.33 percent regardless of whether the funds are disbursed to a community or deposited to a reserve account as security for bonds.

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<sup>1</sup> The Federal and state shares are calculated as follows:

	<u>Amount</u>	<u>Percentage</u>
Federal grant	\$ 100	83.33
state match	<u>20</u>	<u>16.67</u>
Total SRF funds	<u>\$ 120</u>	<u>100.00</u>



## KEY DOCUMENTS

In addition to the capitalization grant terms and conditions, there are several other key documents relating to a state's SRF program:

- Operating Agreement (OA);
- Intended Use Plan (IUP);
- Annual Report;
- Annual Review; and
- the state's Single Audit Report.

**Operating Agreement.** At the option of the state, the organizational and administrative framework and those procedures of the SRF program that are not expected to change annually may be described in an OA. The OA is incorporated by reference in the capitalization grant agreement [40 CFR 35.3130(b)].

**Intended Use Plan.** Prior to each capitalization grant award, the state must prepare a plan identifying the intended uses of the funds in the SRF and describing how those uses support the goals of the SRF. The IUP must be prepared annually and must be subjected to public comment and review before being submitted to EPA (40 CFR 35.3150).

**Annual Report.** The state must provide an Annual Report to EPA. The Annual Report includes information essential to EPA in evaluating the SRF program, and includes how the state is meeting the goals and objectives of the program [40 CFR 35.3165(a)].

**Annual Review.** The Annual Review is EPA's assessment of the success of the state's performance of goals and activities identified in the IUP and Annual Report. It also addresses compliance with the terms of the capitalization grant agreement [40 CFR 35.3165(c)].

**State's Single Audit Report.** OMB Circular A-133 (formerly A-128) requires a state to conduct an audit. The scope of this audit includes work that can be of value to the auditor conducting the SRF financial statement audit.

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## **CHAPTER 3 - PLANNING THE AUDIT**

Conducting an audit of the financial statements of the SRF requires that the audit be properly planned and supervised. Generally Accepted Government Auditing Standards (GAGAS) for financial statement audits have incorporated the fieldwork standards established by the American Institute of Certified Public Accountants (AICPA). The guidance in the AICPA Statement of Auditing Standards (SAS) No. 22, *Planning and Supervision*, provides procedures applicable to planning and supervising an audit.

The auditor plans the audit to determine an effective and efficient way to obtain the evidential matter necessary to report on the financial statements. The nature, extent, and timing of planning vary with the size and complexity of the SRF, the auditor's experience with the particular SRF, and the auditor's knowledge of the SRF's operations. Audit risk and materiality are also important considerations during the planning stage. Planning the audit is the key to a quality audit, and requires the involvement of senior members of the audit team. Although concentrated in the planning phase, planning is performed throughout the audit. For example, results of the internal control phase have a direct impact on planning the substantive audit procedures.

In planning the audit, the auditor needs to: (1) determine the audit scope; (2) obtain key documents and information; (3) obtain an understanding of the SRF; and (4) define the engagement with the state and arrange an entrance conference.

### **AUDIT SCOPE**

An audit of a state's SRF financial statements should include the SRF financial statements for the most current unaudited period. The EPA regional SRF Coordinator should be contacted prior to initiating the audit engagement to assist in determining the period of audit. Typically, the SRF financial statements should be available from the state's Annual Report on the SRF program. The auditor is reminded that the SRF financial statements are those of the state's SRF management and as such, the state is required to provide certain explicit and implied assertions with their financial statements (see Chapter 4 - Management Assertions and Internal Control).

### **KEY DOCUMENTS AND INFORMATION**

Preliminary planning for the audit engagement includes obtaining the key documents discussed in Chapter 2. In addition, the region's SRF Coordinator should be contacted to obtain EPA's perspective on strengths or weaknesses of the state's SRF program and names of state contacts.

Auditors should carefully review and assess the key documents for planning the performance of the audit. Auditors are encouraged to build upon the work performed by others, provided that the auditor is willing to accept full responsibility for the work. In such cases, the nature, timing and extent of tests performed may be able to be reduced because of work performed by EPA during its annual review, or by other auditors performing SRF related audits or audits required by OMB Circular A-133.

## **OBTAINING AN UNDERSTANDING OF THE SRF**

The auditor should obtain a sufficient understanding of the SRF to plan and perform the audit in accordance with GAGAS and specific EPA requirements. This consists of gathering information to obtain an overall understanding of the SRF, the origin and history of the state's SRF, size, organizational structure, mission, operational strategies, inherent risks, control environment, and internal controls.

The auditor's understanding of the entity and its operations does not need to be comprehensive but should include:

- SRF management and organization;
- External factors affecting operations;
- Internal factors affecting operations; and
- Accounting policies and procedures.

**SRF Management and Organization.** As a starting point in gaining an understanding of the SRF, the state legislation and implementing regulations that established the SRF should be reviewed. The legislation will normally include the type of fund established for the SRF, indicate how the SRF will be organized and managed, and establish levels of authority. Whether the SRF is established within an existing state department or as an independent entity will affect the accounting policies and internal controls of the SRF. Legislation and regulations may also include information about cash management, investments, debt issuance, and interaction with other state departments or funds.

The auditor should identify key members of management and obtain a general understanding of the organizational structure. The main objective is to understand how the entity is managed and how the organization is structured. The style of management will have a significant impact on the financial statements, internal control structure and effectiveness, and the conduct of the audit.

One of the first steps in understanding the SRF and the organization is to determine the type of fund that the state has established for the SRF. The type of fund used will

dictate many of the accounting principles and policies to be followed, as well as the presentation of the financial statements. Since one of the primary objectives of the SRF is to provide a permanent financing institution in each state, much like a bank or loan company, the accounting and the financial statements should be similar to those of a financial institution. As such, the preferred method of accounting for the SRF is as a proprietary (enterprise) fund. However, many states account for the SRF as a special revenue fund or a trust fund, and some states account for the SRF as part of the general fund.

**External Factors.** Regardless of how the state accounts for the SRF, there are a number of factors that affect the operations, both external and internal. External factors might include: (1) source of funds for the state matching requirement; (2) whether the state has "leveraged"<sup>2</sup> its program; (3) current political climate; and (4) relevant legislation.

**Internal Factors.** Internal factors might include the: (1) type of fund used to account for the SRF; (2) size of the fund; (3) composition of the loan portfolio; (4) structure of the program and complexity of operations; (5) number of other governmental agencies involved; (6) qualifications and competence of key personnel; and (7) turnover of key personnel.

**Accounting Policies and Procedures.** In identifying accounting policies and procedures, the auditor should consider applicable accounting principles and pronouncements, including whether the entity is likely to be in compliance with those principles. The auditor should also consider changes in accounting principles that affect the entity, and whether entity management appears to follow aggressive or conservative accounting policies. Understanding the state's SRF operations in the planning process enables the auditor to identify, respond to, and resolve accounting and auditing problems early in the audit.

## **ENGAGEMENT LETTER AND ENTRANCE CONFERENCE**

An engagement letter should be sent to the state (with a copy to the Regional SRF Coordinator). At a minimum, the letter should include the following items: (1) announcement of the audit, including the audit scope and objectives; (2) proposed entrance conference date; (3) information needed prior to or at the entrance conference; (4) schedules to be prepared by the state; and (5) name of the audit team leader. A sample engagement letter is included in Appendix C.

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<sup>2</sup>

Leveraging is when a state issues debt to increase the amount available for loans. The SRF can be used to guarantee the debt, and interest earnings can offset the interest on the debt. There are a number of variations on two basic methods used by the states. Specific auditing and financial reporting issues involved will depend on the leveraging method.



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## **CHAPTER 4 - MANAGEMENT ASSERTIONS AND INTERNAL CONTROLS**

The majority of an independent auditor's work in forming an opinion on the financial statements consists of obtaining and evaluating evidential matter concerning the assertions in the financial statements. The internal control system consists of policies and procedures established by management to ensure that its assertions are valid.

### **MANAGEMENT ASSERTIONS**

The financial statements of the SRF are the representations of management. The financial statements are prepared according to various management assertions, which are either explicit or implied.

The management assertions in the financial statements include the following:

- **Existence or occurrence:** The assets and liabilities of the organization exist at a given date, and recorded transactions occurred during the period.
- **Completeness:** The financial statements include all transactions and accounts that should be included.
- **Rights and obligations:** Assets are proper rights of the organization and liabilities are proper obligations.
- **Valuation or allocation:** The accounts are recorded and presented at appropriate amounts.
- **Presentation and disclosure:** All components of the financial statements are properly classified, described and disclosed.

The audit serves as an independent review of the assertions, and verifies that management's assertions are accurate. After the internal controls have been reviewed and documented, the effectiveness of management's assertions is assessed, as discussed in the section titled "Assessing Control Risk."

Appendix D lists each management assertion, along with potential misstatements, and specific control objectives to address each assertion. Appendix E is a flowchart depicting management assertions and the relationship to the internal control review process.

## INTERNAL CONTROLS

Internal controls can be reviewed once an understanding of the organization, management and accounting policies is obtained. The AICPA's second standard of fieldwork states "a sufficient understanding of internal control is to be obtained to plan the audit and determine the nature, timing, and extent of tests to be performed." SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, provides guidance on the auditor's consideration of an entity's internal controls in financial statement audits performed in accordance with generally accepted auditing standards.

Internal control is defined as:

A process—effected by the entity's board of directors, management, and other personnel—designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (a) reliability of financial reporting, (b) effectiveness and efficiency of operations, and (c) compliance with applicable laws and regulations.

The objectives are what the entity strives to achieve. The components of the internal control system represent what is needed to meet those objectives. The internal control system consists of five interrelated components: the control environment, risk assessment, control activities, information and communication, and monitoring. The controls that are relevant to an audit pertain to the state's objective of preparing financial statements that are fairly presented in conformity with generally accepted accounting principles or other comprehensive basis of accounting.

## INTERNAL CONTROL STRUCTURE

The objectives of the internal control structure are to provide reasonable assurance that assets are safeguarded against loss, and that transactions are properly recorded to validate the management assertions. Following are the elements of the internal control system, and their relationship to the audit of the financial statements.

**Control Environment.** The control environment sets the overall tone of the organization. It represents the collective effect of various factors on establishing, enhancing or mitigating the effectiveness of specific policies and procedures. The control environment reflects the overall attitude and actions of the SRF program within the state, including legislative, management, staff and others concerning the importance of the controls. The control environment includes such factors as:

- Integrity and ethical values;

- Commitment to competence;
- Legislature or governing board;
- Management's philosophy and operating style;
- Organizational structure;
- Assignment of authority and responsibility; and
- Human resources policies and practices.

The importance of these factors will vary according to the size, complexity, and sophistication of the SRF program. The auditor should obtain enough knowledge of the control environment to understand the attitude of management and its actions regarding the control environment. Auditors should also be aware that the substance of management's policies and actions are more important than the form because appropriate policies and procedures may be established, but not followed.

To judge the effectiveness of the control environment, the auditor needs to consider these factors and how the factors affect the audit. However, not all factors will have the same weight in each case, and the auditor does not need to understand each factor to the same degree of detail. The extent of understanding for each factor is a matter of professional judgement.

**Risk Assessments.** Risk assessment is the identification of risks that may prevent the SRF program from meeting its organizational objectives, and forms the basis for how the risks should be managed. The risk assessment for financial reporting purposes involves identification, analyses, and management of risks relevant to preparing financial statements in conformity with generally accepted accounting principles.

Risks can be internal, external or both. Risks may affect the organization's ability to record and process financial data consistent with the management assertions. Risks can arise or change due to:

- Changes in operating environment;
- New personnel;
- New or revised information systems;
- Rapid growth or technology changes;

- Reorganizations; or
- Accounting pronouncements.

Sufficient knowledge of the organization's risk assessment process is necessary to understand how management considers risks relevant to financial reporting objectives, and determine what actions should be taken to address those risks. Auditors need to understand that the organization's risk assessment will likely differ from the auditor's. The auditor's risk assessment is mainly concerned with likelihood that material misstatements in the financial statements could occur. The organization's risk assessments will include factors outside the financial statements.

**Control Activities.** Control activities are the policies and procedures that assist management in carrying out its directives. Control activities are generally the specific activities or procedures that management has established to address the risks that the management assertions contained in the financial statements are met. Control activities applicable to the SRF would include the following:

- Performance reviews;
- Information processing;
- Physical controls; and
- Segregation of duties.

A thorough understanding of the control activities is vital to planning the audit. As information is obtained about other components of the internal control system, information about the control activities is also obtained. For example, when reviewing the cash receipts and disbursement functions, the auditor would also determine if bank accounts are reconciled, and who reconciles them. The presence or absence of control activities learned from reviewing other activities should have an effect on the auditors decision to devote additional time to certain areas of the audit.

The goal is to determine whether the internal controls are adequate to identify potential misstatements in the financial statements, and to design substantive tests to provide reasonable assurance that misstatements do not occur.

**Information and Communication.** The information and communication system relevant to financial reporting includes the accounting system. The system consists of methods and procedures to record, process, summarize and report transactions, and to maintain accountability over assets and liabilities. The accounting system has a significant effect on the potential for misstatement, and the design of substantive audit tests and procedures.

The system should be effective in:

- Identifying and recording all valid transactions;
- Describing the transactions in enough detail to permit proper classification of transactions;
- Measuring the proper value of transactions;
- Determining that the transactions are recorded in the proper time period;
- Presenting the transactions and related disclosures in the financial statements; and
- Allowing and promoting communication among employees.

The type of fund that the state has established for the SRF will dictate many of the accounting principles and policies that are followed, as well as financial presentation of the financial statements. One of the objectives of the SRF was to provide a permanent financing institution in each state, much like a bank or loan company. Therefore, the accounting and the financial statements should be similar to those of a financial institution. Accounting for the SRF as an enterprise fund<sup>3</sup> allows all transactions to be recorded in a single fund, including leveraging operations, and facilitates preparing the financial presentation necessary to assess the financial position and results of operations. However, some states account for the SRF in other types of funds, most commonly in Special Revenue funds, although at least one state uses a trust fund, and another accounts for the SRF as part of the general fund. Regardless of the fund type used, the auditor should thoroughly understand the accounting records, supporting information, and specific accounts included in the financial statements for the fund type used by the state.

If the SRF is not accounted for as an Enterprise fund, there will likely be several other types of funds or account groups involved, such as the general fund, debt service funds, capital outlay funds, and the long-term debt and fixed assets groups of accounts. Auditors should have a complete understanding of how the different funds are interrelated for the financial statements to fairly present the financial position of the SRF.

**Monitoring.** The effectiveness of management's specific policies for monitoring internal controls, including internal and external audits, should be evaluated. Internal

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Non-expendable trust fund would also be acceptable, as the accounting is the same as for enterprise funds.

and external audits are important aspects of monitoring internal controls, but monitoring can also include the normal recurring operations of the organization. For example, errors can be discovered during the normal operations that could identify a control activity or procedure that is not effective.

## **OBTAINING AN UNDERSTANDING OF INTERNAL CONTROLS**

The primary methods of obtaining an understanding of the internal controls needed to make decisions about the extent of reliance that can be placed on the internal control system include:

- Prior experience with the organization;
- Inquiries of appropriate management, supervisory and staff personnel;
- Inspection and testing of documents and records; and
- Observation of the organization's activities and operations.

The extent of the procedures will vary with the size and complexity of the SRF, previous experience, the particular controls involved, and professional judgement.

## **DOCUMENTING THE UNDERSTANDING**

The understanding of Internal Controls should be properly documented in the work papers. The exact form and extent of the documentation will vary according to the size and complexity of the organization.

The documentation required for a small, direct loan program with a small number of loans would not be as extensive as a leveraged program with hundreds of loans, bonds payable, bond reserves, and other complexities. A small program could be adequately documented by a memorandum in the files that describes the system, whereas a larger program may require several files, flowcharts, questionnaires, and other audit aides. Regardless of the form and quantity, the documentation should include information on:

- The classes of transactions that are important to the SRF;
- How the transactions are initiated;
- The source documents;
- The accounting processing, including computer files;
- The chart of accounts;

- Samples of documents, journals, ledgers and reports generated by the financial reporting system;
- Descriptions of control activities, and;
- How the state provides the matching share of the SRF; and
- The financial reporting process used to prepare the financial statements.

If the SRF is a leveraged program, the amount of documentation would generally increase, and should address details on the leveraging, including:

- A description of the leveraging method used;
- The type of bonds issued, such as general obligation, revenue, or other bonds;
- How the SRF issues and accounts for bond proceeds, and the related liabilities, reserves, interest earned and paid, bond maturities, and other related matters;
- Debt service requirements; and
- Financial disclosure requirements, such as interest rates, covenants, contingencies, and restrictions that may be placed on other assets.

## **ASSESSING CONTROL RISK**

After the internal control structure has been reviewed and documented, auditors need to assess the risk of a material misstatement in the financial statements. The review procedures should be sufficient to obtain an understanding of internal control that will support a low assessed level of control risk. Assessing control risk is a process of evaluating the design, effectiveness, and structure of the internal controls in preventing or detecting a material misstatement in the financial statements.

Control risk should be assessed for relevant assertions that are related to each significant account balance or class, and may be assessed for specific objectives that relate to the assertions.

However, not all assertions need the same level of evaluation because some assertions may not be significant for certain account balances or classes of transactions. Similarly, not all assertions need to be assessed for every account because some assertions are affected by the same controls. For example, the assessment of control risk of the existence, rights and obligations, and gross valuation

of loans receivable could be made concurrently because the assertions are all affected by the same controls.

**Low Control Risk.** Assessing control risk at less than the maximum is related to the effectiveness of internal controls in preventing a material misstatement of the financial statements. The process involves identifying specific controls for specific assertions that are likely to prevent a material misstatement, and testing the effectiveness of the specific controls.

The controls can directly or indirectly relate to a particular assertion. The more direct the control, the more effective the control is likely to be in reducing control risk.

Control tests are intended to assess the effectiveness of the control, and whether the control is suitable to prevent or detect misstatements in financial statement assertions. Tests normally include procedures such as making inquiries of appropriate personnel, inspecting documents and reports, and observing specific controls and procedures. A combination of procedures may be necessary to obtain a level of understanding sufficient to make an assessment of the control risk.

When the control risk is considered to be less than maximum, the files should contain enough evidential matter to support the assessment. The evidential matter that is sufficient to support the assessed level of risk is a matter of judgement, and can vary from year to year. For complex organizations and programs, flowcharts, questionnaires, and decision tables may be helpful in applying the tests, analyzing the results, and documenting the assessed level of risk. Decisions about the nature, extent and timing of tests of controls also affect the degree of assurance the evidential matter provides.

**Maximum Control Risk.** Assessing control risk at the maximum means that there is a risk of a material misstatement in an account that would not be detected or prevented by the internal controls. Control risk should be assessed at the maximum level for some assertions if the review of the internal control structure reveals that:

- Controls are unlikely to pertain to an assertion; or
- Controls are not effective.

The level of assurance needed from substantive tests remains the same whether control risk is assessed at the maximum because of audit efficiency reasons or ineffective controls. The fact that the controls are ineffective may also raise questions about the auditability of the account, or the entire organization. In such cases, changing the nature, timing and extent of substantive procedures may be warranted.



The type of fund used to account for the SRF will also influence control risk assessments. For example, a leveraged program accounted for as a special revenue fund would generally have a higher risk of misstatement than a similar program accounted for as an enterprise fund because not all transactions are accounted for in the special revenue fund. The interaction between other funds and combining the other funds into the financial statements would generally increase the chance of a material misstatement in the financial statements.

**Nature, Extent and Timing of Tests.** The types of tests depends on the particular assertion being tested, and the evidential matter that is available to evaluate the controls. Some controls are well documented, and for others, such as segregation of duties, documentation may not exist. Assessing whether there is adequate segregation of duties would be primarily by observations of the operations and inquiries of appropriate personnel. Evidence obtained directly, such as by observing the operations of a department, provide more assurance than evidence obtained by other methods, such as inquiries. However, auditors should be aware that the control observed may not be followed if the auditors were not present.

More extensive tests normally provide increased evidence about the consistency of the application of a control, and may support a lower assessed control risk. For example, observing a daily procedure only once may not be representative of how the procedure is followed on other days, or by other people. Additional observations or other procedures may be advisable or necessary to obtain a thorough understanding of the control, and the consistency of the application.

The timing of audit tests also influences the degree of risk associated with the assertion. Tests that pertain to only one point in time would be appropriate for some tests, but not others. The results of tests should be evaluated with the timing of the test in mind. When tests may not be representative of the entire audit period, other tests or procedures should be conducted to provide evidential matter about the entire period. Evidence obtained from prior audits and interim periods may provide the additional information needed to assess the control risk. However, if the controls or procedures have changed since the prior audit work, reliance on prior work would not be appropriate. The length of time that has elapsed between the prior work and the current audit would also influence the reliance placed on the prior work. When using prior or interim work, the auditor should consider:

- Evidence about changes in the effectiveness of the design of the controls:
  - Are the system and controls in place the same as in the prior or interim period?
  - Is the organization the same, or has it changed?
- Evidence about changes in operating effectiveness:

**Adverse Conditions:**

- Has there been a change in management attitudes about internal controls?
- Is there any change in the nature or quantity of the transactions processed?
- Is employee turnover excessive?
- Were there staff reductions that increased the workload for remaining employees?

**Positive Conditions:**

- Are procedures manuals well documented and followed?
- Is the department closely supervised, with good communication lines and lines of responsibility?
- Have there been periodic reviews by internal auditors?
- Are computer controls adequate?

If adverse conditions are not present, the prior audit evidence would be more relevant, and could be given greater reliance. If there have been a number of changed conditions, relying on evidence gained from prior audit work would not be appropriate.

When interim audit work is performed for the current year, the auditor needs to document that the procedures in place during the interim period reviewed are still valid, and being followed. If the procedures, or any other aspects of the organization have changed that effect the controls being tested, then the interim work should not be relied upon for assessing the control risk.





## **CHAPTER 5 - AUDITING THE FINANCIAL STATEMENTS**

This chapter focuses on the first audit objective: *To determine whether the SRF financial statements are presented fairly in all material respects in conformity with GAAP.* It provides a general overview of the types of funds and accounts that may support the SRF financial statements, and identifies the auditing and reporting concerns that face SRF auditors. States use different methods of accounting for SRFs and its operations. As such, this guide cannot cover every situation in all states, and professional judgement must be used in conducting audits.

### **FINANCIAL REPORTING ENTITY AND SRF FINANCIAL STATEMENTS**

With the audit objective focusing on the SRF financial statements, ideally only the accounts of the SRF should be audited, with the opinion on the SRF financial statements. In some states, however, the organization of the SRF may make it more efficient to audit the financial statements of the entire entity, with supplemental statements supporting the SRF portion. In the latter situation, it is essential that the supplemental SRF financial statements be included in the auditor's report.

### **BASIS OF ACCOUNTING AND TYPES OF FUNDS**

Understanding the basis of accounting and type of fund chosen by a state for the SRF is an essential first step in auditing the SRF financial statements. The basis of accounting determines when transactions are recorded, and the type of fund (the measurement focus) determines what transactions and events are recorded.

The National Council of Governmental Accounting (NCGA) Concepts Statement no. 1, *Objectives of Accounting and Financial Reporting for Governmental Units*, concludes that the goals of governmental accounting and financial reporting are to:

*(1) provide financial information useful for making economic, political, and social decisions, and demonstrating accountability and stewardship and (2) provide information useful for evaluating managerial and organizational performance.*

An important element in achieving these goals is the selection of a basis of accounting and type of fund for the SRF that provides the necessary information to meet these goals. The selected basis of accounting and type of fund have a significant effect on the accounting principles governing the SRF.

Auditor's should also keep in mind that a state may maintain its accounting records on one basis of accounting, and prepare the financial statements of the SRF on a different basis. Many states account for the SRF on the cash basis during the year, and make

adjustments to convert to the accrual or modified accrual basis to present the financial statements according to GAAP.

**Basis of Accounting.** The basis of accounting determines when revenues, expenses, expenditures, and transfers are recorded in the accounting records and reported in the financial statements. The three primary bases of accounting encountered are cash, accrual, and modified accrual.

**Cash.** Under the cash basis, receipts are recorded as revenues, and disbursements are recorded as expenditures<sup>4</sup>. The balance sheet has only two accounts, cash and fund balance. The operating statement (income statement) also has only two accounts, revenues and expenditures. The excess of revenues over expenditures is "closed" to fund balance at the end of the accounting period.

The NCGA has concluded that cash is not an appropriate basis of accounting for governmental organizations. Fortunately, states that use the cash basis of accounting also maintain records of loans made and repayments. With such supplemental information, the states are able to prepare SRF financial statements on the modified accrual method. If the accounting is maintained on the cash basis, it will be necessary for the state to modify the SRF financial statements to reflect a presentation of financial information on the accrual or modified accrual bases.

**Accrual.** The accrual basis reflects the financial effects of transactions and other events that have financial consequences in the period in which they occur rather than in the periods in which the cash is received or paid. The elements of accrual accounting include:

- Properly matching revenues earned against costs incurred;
- Deferring expenditures and subsequent amortization of deferred costs;
- Deferring revenues until earned (revenues received in advance);
- Capitalization of certain expenditures and depreciation of capitalized costs; and
- Accruing revenues earned and expenses incurred.

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<sup>4</sup>

The term *expenditures* is used to indicate decreases in the financial resources (or increases in current liabilities). Expenditures can be for capital items, such as constructing new buildings, or operating expenditures, such as salaries and benefits. Expenditures of a governmental entity are not the same as expenses of a commercial enterprise.

Very few governmental agencies use the full accrual basis because measuring income is not the primary objective of governmental entities.

**Modified Accrual.** Most government entities use a combination of the cash and accrual basis known as the modified accrual basis. The modified accrual basis is appropriate because the primary objective of accounting for governmental funds is to reflect the sources and uses of funds, and not to measure income for the period. The modified accrual basis records revenues (including issuance of debt and funds received for other governmental units) when they are susceptible to accrual. In order to be susceptible to accrual, it needs to be both measurable and available to finance current expenditures.

For example, interest on loans that has not been received (this assumes loan payments are made once or twice per year) would be accrued at the end of the year because it meets both criteria: interest is measurable and available to meet obligations of the current period. The calculation would be made on the number of days from the date of the last payment to the end of the year, multiplied by the interest rate. Most expenditures, such as salaries, supplies and other administrative expenses, would be accrued because they are measurable when incurred. However, loan funds committed but not fully paid out to a loan recipient at year end would not be accrued because the loan agreement could be canceled.

**Types of Funds.** In addition to selecting a basis of accounting for the SRF, states also use different types of funds to record SRF activity. The following section briefly describes the types of funds that may be encountered, and distinctions between the types as they apply to the SRF.

**Proprietary Funds.** A proprietary fund is used to account for governmental activities that are similar to commercial enterprises. The two types of proprietary funds are Enterprise Funds and Internal Service funds. The most common examples of enterprise funds are airports, hospitals, state lotteries, state insurance funds, and public utilities, such as local water, sewer, and electric operations. Internal service funds operate the same, but provide goods and services only within the organization, such as motor pools, data processing, and centralized maintenance. General Services Administration is a good example of an internal service fund.

Accounting for enterprise funds is similar to commercial enterprises because the activities performed are basically the same, however, the purpose of the fund is different. The purpose of a proprietary fund is to provide a service to users at a reasonable cost, whereas the purpose of a commercial entity is to maximize its return on invested capital.

Enterprise fund accounting works well for the SRF, and is the preferred fund type for the SRF. The SRF program was established as a permanent financing source in each state to provide financing to qualified agencies at reduced interest rates. Since the SRF acts like a financing company or lending institution, the accounting should be similar. The advantage to the proprietary fund is that all transactions, including those of leveraged funds, can be accounted for within a single fund. Having all transactions recorded in one fund also facilitates financial reporting, and make the financial statements easier to understand.

**Nonexpendable Trust Funds.** Nonexpendable trust funds are used to account for fiduciary operations where the trust principal (capitalization grants) may not be expended and must remain intact. Earnings can either be expendable or nonexpendable. If used for an SRF, the earnings would be nonexpendable. A number of states account for SRF's as nonexpendable trusts. The accounting is the same as for enterprise funds.

**Special Revenue Funds.** Special revenue funds are established to account for the proceeds of a specific revenue source (other than special assessments, expendable trusts or sources for major capital projects) that are legally restricted to expenditures for specified purposes. Examples of special revenue funds would be a state gasoline tax for which expenditures are restricted for road and highway maintenance, and a school district that is financed partially by property taxes. The NCGA recommends that special revenue funds be used only when legally mandated.

Many states account for the SRF as a special revenue fund, primarily because the SRF replaced the construction grant program. These states continued accounting for the SRF as they did for the construction grants program.

**General Fund.** Use of a general fund to account for a SRF is the least desirable option, however, at least one state operates its SRF as part of a general fund.

Every state or local government has a general fund. The purpose of a general fund is to account for all financial resources of an entity except for those resources that must be accounted for in a special purpose fund. The general fund is not used to account for fixed assets, long-term debt, trust and agency funds, proprietary funds, or special revenue funds. General funds normally use the modified accrual basis of accounting. The measurement focus for the general fund is to determine what transactions and events should be recorded, and identify the net financial resources available for, appropriation and expenditure.

The general fund accounts for the current operations of the government. Expenditures are generally for basic governmental services such as public safety, health and welfare, and general government administration, such as accounting, auditing, building departments, data processing and similar activities. Revenues for the general fund



usually are derived from income taxes, property taxes, sales taxes, fines and penalties, permits and licenses, and other sources.

## **AUDIT CONSIDERATIONS**

The basis of accounting and fund type address when transactions are recorded and what transactions are recorded. Regardless of the state's basis of accounting and fund type, there are certain common audit considerations for all SRF financial statements.

Cash and cash equivalents, loans receivable, contributed capital and fund balances, and revenues and expenses are material accounts to the SRF financial statements. Conceptually, common audit procedures (not audit steps) can be applied, regardless of the accounting or fund type.

**Materiality.** The concept of materiality recognizes that some matters are important for the financial statements to be presented fairly, in conformity with GAAP, while other matters are not. Financial statements are materially misstated when the effects of the omission(s) or misstatement(s) of accounting information make it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission(s) or misstatement(s). Misstatements can occur because of errors, the failure to apply accepted accounting principles, departures from fact, or omissions of necessary information.

Determining what is material is a matter of professional judgement that will vary depending on the state and the circumstances. What is material to one state may not be material to another. What is material in one year may not be material in another year. Auditors should plan the audit and perform auditing procedures so that the risk of a material misstatement is at a low level.

**Cash and Cash Equivalents.** Auditing cash depends primarily on how the SRF is organized. If cash is controlled by a state treasurer (or similar department separate from SRF operational management), SRF management may have little or no involvement in the actual disbursement of cash. If the SRF is a separate agency or authority, its cash may be totally controlled (including disbursement) by SRF personnel. In the latter situation, the cash may be with a commercial bank, and risk of misstatement of cash balances could be substantially increased.

The objective of auditing cash is to obtain reasonable assurance that:

- The recorded balances exist and are owned by the SRF;
- The recorded balances are complete and stated at realizable amounts;

- Balances are properly presented in the financial statements;
- Restrictions on the availability or use of cash are identified and disclosed; and
- Cash receipts, disbursements and transfers between accounts are recorded in the proper period.

The specific of audit steps and procedures will depend on the circumstances, but generally include:

- Obtaining a schedule of cash for the SRF;
- Making sure the cash balances agree with the trial balance;
- Reviewing and testing reconciliations at the balance sheet date;
- Confirming cash balances and interest earnings with the bank, state treasurer or other department responsible for cash;
- Reviewing and testing transactions before and after the balance sheet date to determine if the transactions are in the proper period; and
- Reviewing and testing transfers between accounts.

Additional procedures would be involved if the SRF has accounts with commercial banks. Auditors may want to obtain cut-off statements to review checks that were outstanding at the balance sheet date that cleared after year end, and determine that cash was properly stated. If there are multiple bank accounts, transfers between accounts should be scrutinized to determine if all transactions are legitimate, and properly recorded.

**Disclosures:** Cash and cash equivalents need to be disclosed in SRF financial statements according to GASB Statement No. 3, *Deposits with Financial Institutions, Investments [Including Repurchase Agreements] and Reverse Repurchase Agreements*. Also, some cash balances may be restricted, and not available for the operations of the SRF. The terms of any restrictions, such as uses or collateral for other activities, should be fully investigated and disclosed.

Cash may also include investments of excess cash, often called "cash equivalents." Whether the cash is a cash equivalent will depend on the particular investment. The type of investment, terms, conditions, maturity and availability will govern whether the investment is cash or not. Typically, money market funds, excess funds with the state treasurer, certificates of deposits and similar investments are considered cash.

**Loans Receivable.** Loans receivable will normally be the most significant asset of the SRF, and also generate the largest portion of revenue. Loans should be reviewed to determine how: (1) construction period interest is calculated; (2) such interest affects the final loan amount; and (3) the transaction is reported in the SRF financial statements.

The objectives of the audit procedures performed are to provide reasonable assurance that:

- Loans exist at the stated values and are owned by the SRF;
- Loans are properly classified, described and disclosed in the financial statements;
- Recorded loans include all such assets of the SRF, and the financial statements include all related transactions during the period;
- Interest income, fees and costs and the related balance sheet accounts (accrued interest receivable, unamortized fees and costs, unamortized premiums or discounts) are properly measured and recorded; and
- Commitments, guarantees, recourse provisions and collateral are properly disclosed.

Basic audit procedures for loans receivable would include:

- Obtaining a schedule of loans at the balance sheet date;
- Inspecting loan documents to determine whether the loan was properly approved, and include the amount, terms, fees, interest rates, purpose, repayment terms, and other conditions;
- Reviewing draws on loans and calculations of interest earned and accrued;
- Confirming loans and terms with borrowers;
- Performing analytical procedures on the loan portfolio to identify trends or possible collection problems; and
- Reviewing loans and loan activity to determine if all loans are collectible. If not, an allowance for uncollectible loans should be established.

If loan fees are charged by the SRF, FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and*

*Initial Direct Costs of Leases*, which has been incorporated by GASB 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, will apply. Basically, FASB 91 requires any fees to be accounted for as an adjustment of the stated interest rate. Many states charge fees for various purposes. FASB 91 and GASB 10 are not applicable only to the banking industry; they are applicable to all loans entered into by a creditor agency.

For leveraged programs, the procedures may vary because the SRF acts as security or guaranty of the borrowers debt, and the audit procedures would need to be expanded to cover the circumstances.

**Disclosures:** Disclosures for loans receivable should include:

- Major groups of loans (leveraged versus direct, completed loans and loans in progress);
- The interest rates and method of recognizing interest income, including loan fees and costs;
- A schedule of principal repayments due by year for next five years;
- Major loan recipients; and
- A discussion of the allowance for uncollectible accounts (or a statement that management considers all loans fully collectible).

There may be other factors that need to be disclosed. For example, if a major loan was refinanced or restructured, the details would need to be fully disclosed.

**Contributed Capital and Fund Balances.** One of the major differences between the type of fund used to account for the SRF is in the area of equity. Regardless of how a state accounts for its SRF, the SRF financial statements need to show cash, loans receivable, and equity. The equity section needs to identify EPA contributions, state matching funds (except where state match is funded by debt from the SRF), and cumulative fund balance/retained earnings.

Under the strict use of the special revenue fund, only fund balance would be reported, as all contributions from EPA and the state matching funds, as well as interest earnings, would be recorded as revenues, and all disbursements would be expenditures. As the excess of revenues over expenditures is closed to the fund balance at the end of each year, the balance sheet would not fairly present the financial position of the SRF, because loans receivable, the major asset of the SRF, would be included as part of fund balance. There would be no distinction in fund balance for EPA's contributions, state matching amounts, or retained earnings.

Since cash basis special revenue funds do not facilitate presenting the financial position of the SRF in a format that meets EPA's needs, most SRF's will be converted to the modified accrual basis for financial statement presentation. A common audit situation, at least in initial audits, will be to "convert" the equity section from the cash basis to an accrual basis. In some cases, the equity section will need to be reconstructed in order to present the financial statements in accordance with GAAP. The specific steps involved in reconstructing equity are beyond the scope of this guide, and will vary depending on each situation, the records available, and the accounting system. However, common procedures that may assist the conversion or reconstruction would be to determine:

- Total assets and liabilities;
- Total EPA capitalization grants awarded;
- Draws made on each grant;
- Total loans awarded, outstanding, and principle repaid;
- The amount of state matching funds, and how the state match is made (direct contribution, bonds from within or outside the SRF); and
- Any accruals or adjustments made in prior years.

Some of this information (which should be obtained as part of normal audit procedures) can be obtained from the Regional SRF Coordinator. Auditors should confirm with the Regional SRF Coordinator the total capitalization grants awarded and draws at the balance sheet date (and for the first week or two following the balance sheet date). Other departments within the state may be able to provide information that would also be helpful.

**Disclosures:** There are a number of disclosures for equity that are useful for EPA and others in managing the program. Total capitalization grants awarded, draws to date, state matching funds (and how state match is made) are all critical disclosures. Additional disclosures will vary depending on the circumstances.

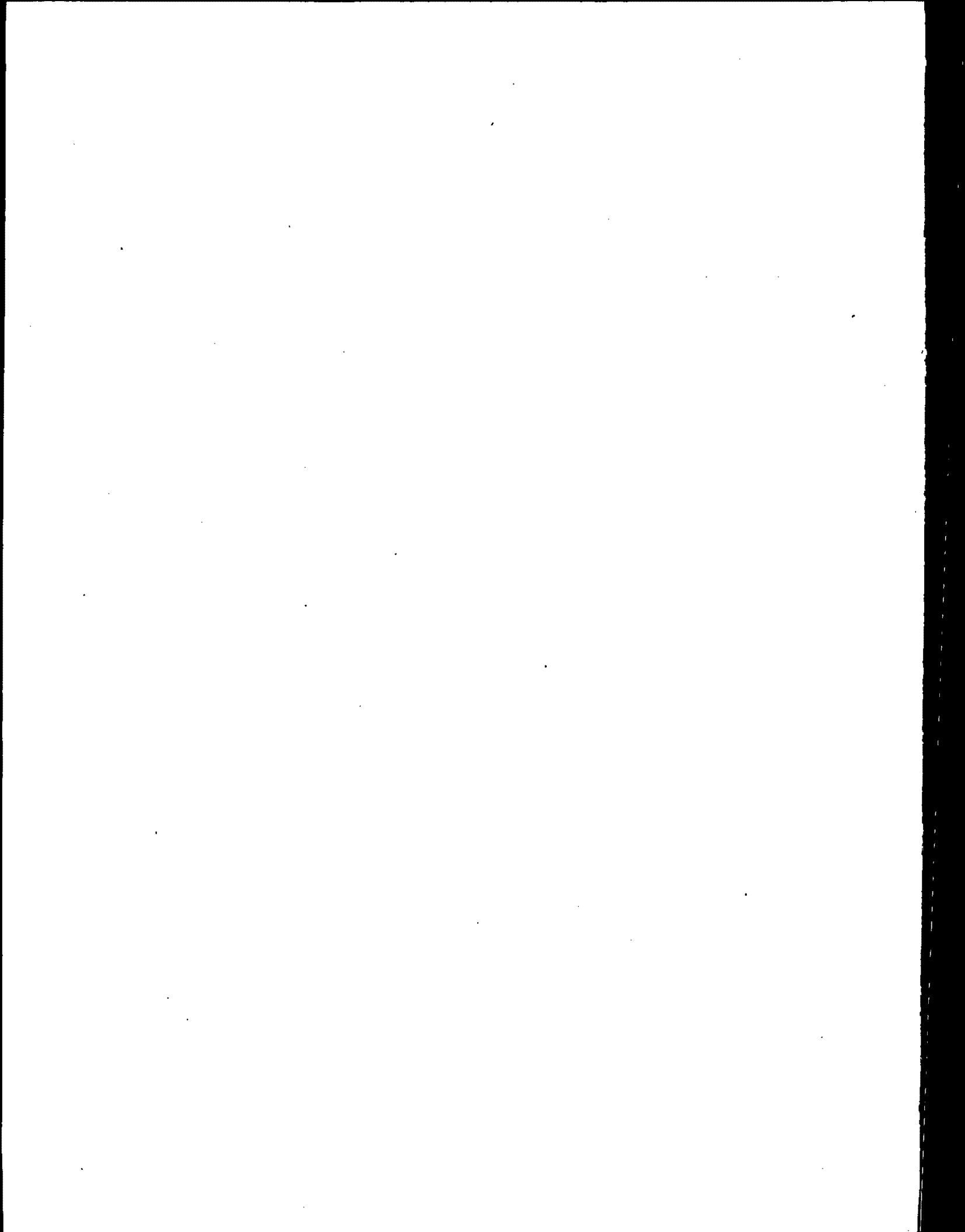
**Revenue and Expense Accounts.** Revenue accounts for the SRF will primarily be interest earned on loans, fees on loans, and investment earnings. Expenses will be for administering the program, and include salaries and benefits, and other expenses. For those programs that issue bonds, interest will likely be a significant expense.

There are no specific audit procedures that are unique to the SRF for auditing revenues and expenses. Specific procedures depend on the situation involved. Generally, interest income on loans can be tested, confirmed and recalculated, as can

interest expense. Analytical procedures and trend analysis applied to various accounts and relationships can provide useful information to verify or substantiate balances, and indicate possible misstatements.

**Other Accounts.** There will likely be other accounts on the balance sheet, such as accrued receivables, investments receivables, accounts payable, accrued expenses and others. Leveraged programs will normally involve more accounts, especially in cash and cash accounts with trustees. Auditing procedures will vary, and depend on the account, amount, and other factors. The auditor is expected to use professional judgement in determining specific procedures to apply to all accounts.

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## CHAPTER 6 - COMPLIANCE AUDITING

This chapter addresses the third audit objective: *To determine whether the state has complied in all material respects with laws, regulations, and the provisions of SRF capitalization grants.* It provides guidance on the compliance matters in SRF capitalization grants that the auditor should address during the audit. Since the significance of a particular compliance matter can vary from state to state, professional judgment in the extent of compliance testing must be exercised.

### BACKGROUND

The compliance auditing necessary to satisfy the audit objective compares favorably with the compliance auditing required by an OMB Circular A-133 audit when the SRF is a major program. The latest OMB Circular A-133 Compliance Supplement (May 1998) includes the SRF program compliance considerations when performing a Single Audit.

### BUILDING ON THE WORK OF OTHERS

In planning the audit effort to satisfy the compliance audit objective, the auditor should ascertain whether other auditors have performed work that will partially or completely satisfy the audit objective. In particular, if an OMB Circular A-133 audit has been performed and the SRF was treated as a major program, the work and work papers of the A-133 audit should be reviewed. In instances where the A-133 audit does not cover the period under audit, the work and work papers of the A-133 audit can still provide valuable insight into the state's compliance with SRF requirements.

Another source of compliance information is the annual review by the Regional SRF Coordinator. While the annual review is not an audit, it often addresses SRF compliance matters and can assist the auditor in determining compliance aspects that may/may not be problem areas.

### COMPLIANCE REQUIREMENTS

#### A. Allowability for Specific Activities.

**Audit Objective:** *To determine that SRF funds are used only for qualified projects, and that the type of assistance provided is allowable.*

The SRF may provide financial assistance: (1) to municipalities, inter-municipal, interstate, or state agencies for the construction of publicly owned treatment works as defined in Section 212 of the Act that are on the state's Project Priority List; (2) for implementing nonpoint source management programs under Section 319 of the Act;

and (3) for developing and implementing estuary management plans under Section 320 of the Act.

There are five types of financial assistance that can be made to local agencies:

1. Loans (not grants).
2. Refinance existing debt obligations.
3. The guarantee or purchase of insurance for local debt obligations.
4. The guarantee of or use as a source of repayment for SRF debt obligations (provided that the net proceeds of the sale of such bonds are deposited in the SRF).
5. Loan guarantees for similar revolving funds established by municipalities or inter-municipal agencies.

In addition, the SRF can be used to pay administrative expenses incurred by the state for managing the SRF (up to four percent of the capitalization grant). Any interest earned from SRF funds must be credited to the fund.

#### **B. Allowable Costs/Cost Principles.**

**Audit Objective:** *To determine that SRF administrative expenses (including indirect costs) are reasonable and allowable in accordance with OMB Circular A-87 cost principles.*

A maximum of 4 percent of all capitalization grants received and added to the SRF may be used for reasonable and allowable costs incurred for administration and management of the SRF program, including management of projects receiving financial assistance.

#### **C. Cash Management.**

**Audit Objective:** *To determine that the state has drawn cash consistent with the SRF requirements.*

The state must establish cash management procedures consistent with the intent of Congress. Cash can only be drawn from EPA for allowable expenses. The timing of the draws depend on the type of assistance, as follows:

1. Loans - when the SRF receives a request from a loan recipient, based on incurred costs, including pre-building and building costs.
2. Refinance or purchase of municipal debt - generally, when at a rate no greater than equal amounts over the maximum number of quarters that payments can be made, and up to the portion of the LOC committed to the refinancing or purchase of the local debt.
3. Purchase of insurance - when insurance premiums are due.
4. Guarantees and security for bonds - immediately, in the event of imminent default in debt service payments on the guaranteed/secured debt.
5. Administrative expenses - cash can be drawn based on a schedule that coincides with the rate at which administrative expenses will be incurred (40 CFR 35.3160).

#### **G. State Matching.**

**Audit Objective:** *To determine that the state provides the matching funds necessary and in a timely manner to earn the capitalization grant.*

States are required to make a match of twenty (20) percent of each grant payment drawn from EPA on or before the date on which the funds are drawn. The matching can be made by direct appropriation, general obligation bonds, revenue bonds, or other methods. The matching requirement also applies to draws for administrative expenses.

#### **H. Period of Availability of Funds and Binding Commitments.**

**Audit Objective:** *To determine that grant funds are drawn timely and binding commitments are entered into timely.*

Grant funds are made available to the states according to a payment schedule (See Chapter 2, Funding the SRF) in the capitalization grant agreement. Generally, payments must start in the quarter in which the grant is awarded, and end no later than eight quarters after the grant is awarded [40 CFR 35.3155(c)]. Cash draw requirements are discussed at 40 CFR 35.3155(d). The date funds are available from EPA leads to a special SRF compliance requirement, binding commitments. States must enter into **cumulative** binding commitments of at least 120 percent of the cumulative capitalization grant payments received one year earlier.

#### **J. Program Income.**

**Audit Objective:** *To determine that interest earned and any other program income is credited to the SRF.*

Interest earned is to be credited to the SRF to increase the fund. Other income/fees generated by the operation of the SRF should be evaluated against the requirements of 40 CFR 31.25.

#### **L. Reporting.**

**Audit Objective:** *To determine that required reports are submitted and in a timely manner.*

The following reports must be submitted as required by the regulations and the grant agreements:

1. Intended Use Plan (40 CFR 35.3150). The state must prepare an Intended Use Plan identifying the intended uses of funds of the SRF, and describing how those uses support the goals of the SRF. The IUP must be prepared annually, and must be subjected to public comment and review before being submitted to EPA. The IUP must be submitted before a capitalization grant can be awarded.
2. Annual Report [40 CFR 35.3165(a)]. The state must provide an annual report to the EPA Regional Administrator according to the schedule in the grant agreement. The Annual Report must establish that the state has: (1) reviewed all projects in accordance with the approved environmental review process; (2) deposited the matching funds as required; (3) complied with Title II requirements of the Act; (4) made binding commitments as required under 40 CFR 35.3135(c); and (5) expended all funds in an expeditious and timely manner. The annual report should also include financial statements, a report on the internal controls, and a report on compliance with Title VI of the Act as required by the capitalization grant agreements.
3. Financial Reports (40 CFR 31.41). The state is required to submit *Financial Status Reports* (SF-269) and *Federal Cash Transaction Reports* (SF-272).

#### **M. Subrecipient Monitoring.**

**Audit Objective:** *To determine that the state monitors loan recipients to ensure that the accounting system used meets the SRF program requirements.*

The state must require recipients of SRF assistance to maintain project accounts in accordance with GAAP as issued by the Governmental Accounting Standards Board. The accounts must be maintained as separate accounts.

## **N. Special Tests and Provisions.**

### **Environmental Review Requirements:**

**Audit Objective:** *To determine whether the state is complying with the environmental reviews requirements of 40 CFR 35.3140 before loan recipients initiate construction under projects.*

The state must conduct reviews of the potential environmental impacts of all Section 212 construction projects receiving assistance from the SRF, including nonpoint source pollution control and estuary protection projects that are also Section 212 projects.

### **Fund Establishment:**

**Audit Objective:** *To determine that the state has established proper accounts and accounting procedures that are sufficient to assure proper accounting for SRF transactions and balances.*

The state is to establish the SRF as a separate account or series of accounts dedicated solely to providing financial assistance in the form of loans and other assistance, but not grants. The state must establish fiscal controls and accounting procedures that are sufficient to assure proper accounting for payments received by the SRF, disbursements made by the SRF and beginning and ending account balances [40 CFR 35.3115 and 40 CFR 35.3135(h)].

### **Loan Repayments and Fund Earnings Credited to SRF:**

**Audit Objective:** *To determine whether principal and interest payments are properly credited to the SRF.*

All loan repayments, including principal and interest, and interest earnings on investments, must be credited directly to the SRF. Repayment of loans must begin within 1 year after project completion, and loans must be fully amortized over not more than 20 years after project completion [40 CFR 35.3120(a)].

### **SRF as Security for Bonds:**

**Audit Objective:** *To determine whether the state has complied with requirements for guaranteeing SRF debt obligations.*

If a state uses the SRF as security or a source of revenue for the payment of principal and interest on revenue or general obligation bonds issued by the state, the net proceeds of the sale of such bonds must be deposited in the SRF [40 CFR 35.3120(d)].

Net proceeds are defined as the funds raised from the sale of the bonds minus issuance costs.

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## **CHAPTER 7 - AUDIT COMPLETION AND THE AUDITOR'S REPORT**

Completion of the audit after conducting the fieldwork involves: (1) obtaining a representation letter from the state; (2) presenting the results of audit to the state; and (3) issuing the auditor's report.

### **REPRESENTATION LETTER**

GAGAS requires that the auditor obtain written representations from management as a part of the audit. The auditor obtains written representations from management to complement other auditing procedures. Written representations ordinarily confirm oral representations given to the auditor, indicate and document the continuing appropriateness of such representations, and reduce the possibility of misunderstandings concerning the matters that are the subject of the representations. SAS No.19 titled *Client Representations* provides guidance to assist the auditor in the content and timing of representations.

Normally, the auditor prepares the representation letter for management to sign. The auditor should work with management to arrive at a mutually acceptable representation letter. However, the representation letter is management's and should be addressed to the auditor. Because the auditor is concerned with events occurring through the date of the auditor's report, the representations should be dated as of the date of the auditor's report. They should be signed by members of management whom the auditor believes are responsible for and knowledgeable, directly or through others in the organization, about the matters covered by the representations.

A sample representation letter is included as Appendix F.

Management's refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion.

### **PRESENTING THE RESULTS OF AUDIT**

In accordance with GAGAS and OIGA policies, the state should be kept informed about the audit progress and tentative findings throughout the audit. At the completion of fieldwork, the auditor should conduct a fieldwork exit conference to convey the tentative results of audit. At or immediately after the fieldwork exit conference, the state should be provided a draft report.

The letter transmitting the draft report should request comments on the factual accuracy of the auditor's findings, and the state's reaction to the auditor's

recommendations. Because the SRF financial statements are management's, any auditor adjustments or footnotes considered (by the auditor ) as material to the statements must be accepted by management. Otherwise, the auditor's opinion on the financial statements may require qualification.

The letter transmitting the draft report should provide a date for receipt of management's comments, and indicate that a final exit conference will be held after receipt and evaluation of management's comments.

The exit conference should be scheduled to present the final results of audit to management, receive any final comments from the state, and advise management on the expected issuance date for the auditor's report. The exit conference is also an excellent opportunity to advise management regarding: (1) matters observed by the auditor during the audit that could improve internal controls or efficiency, effectiveness, economy of the operation of the SRF program, but which do not warrant inclusion in the auditor's reports; and (2) procedures for resolving compliance issues or other matters. Other interested parties, such as the Regional SRF Coordinator, are encouraged to attend the exit conference.

## **THE AUDITOR'S REPORT**

The auditor's report is normally addressed to the state's management responsible for the SRF. It includes three components:

- Financial statements with an opinion (or disclaimer of opinion) as to whether the SRF financial statements are presented fairly in all material respects in conformity with GAAP.
- A report on internal controls related to the SRF financial statements. The report should describe the scope of testing of internal controls and the results of tests, and where applicable, refer to a separate schedule of findings and/or costs questioned.
- A report on compliance that includes an opinion as to whether the state has complied in all material respects with laws, regulations, and the provisions of the SRF capitalization grants.

The auditor's report should also be transmitted to EPA for resolution of audit findings.

A sample auditor's report is included as Appendix G.

**Reports on Compliance.** GAGAS requires that audits of Federal programs include reports on internal controls and compliance. The reports may be included in the report on the financial statements or in separate reports. If the reports are issued separately,

the report on the financial statements should state that those additional reports are being issued.

GAGAS requires auditors to report the scope of the testing of compliance with laws and regulations. If the tests did not exceed the tests the auditors considered necessary for a financial statement audit, then a statement that auditors tested compliance with certain laws and regulations, obtained an understanding of internal controls, and assessed control risk, would be sufficient to satisfy this requirement. GAGAS also allows auditors to report whether or not the tests they performed provided sufficient evidence to support an opinion on compliance or internal controls. As a result, auditors have been able to disclaim an opinion on compliance because the objective of the audit was to express an opinion on the financial statements, not to express an opinion on compliance.

However, one of the principal objectives of auditing the SRF is to determine if the state met the compliance requirements. As such, disclaimers of opinion on compliance are not acceptable. Opinions on compliance must be unqualified, qualified or adverse. Auditors should ensure that the testing of compliance is sufficient to allow them to issue an opinion on compliance. If auditors plan the audit and design tests to address the compliance requirements listed above, an opinion on compliance can be issued.

**Reporting Requirements:** The content of the compliance reports will depend on the conditions noted. Material instances of noncompliance must be reported. Material noncompliance are those instances which could cause auditors to conclude that misstatements from those violations are material to the financial statements. Such instances could include: the failure to follow program requirements; violations of statutes, regulations, or contract terms; or irregularities and other illegal acts. When material instances of noncompliance are discovered, the report should include:

- Identification of the material noncompliance noted;
- A statement that the noncompliance was considered in forming an opinion on whether the financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles; and
- Identify and question any costs as a result of the noncompliance.

This EPA audit guide establishes the reporting requirements for audits of SRFs. The AICPA standards require that reporting for program specific audits follow the reporting requirements of Federal audit guides. The AICPA has established formats for reporting that should be followed by all auditors, and issued SOP 98-3 (Statement of Position) for the revised reporting requirements of A-133. The AICPA expects to update its single audit guidance to conform to A-133 revisions for audits of organizations receiving Federal awards. It will replace current guidance presented in the audit guide *Audits of*

*State and Local Governmental Units*, and will include guidance on program-specific audit reports. A sample report on compliance, based on draft AICPA guidance, is included in Appendix G.

For states that currently conduct audits of the SRF, the state must ensure that the audits are performed in accordance with GAGAS and the EPA audit guide, and contain the required reports, whether the audit is performed by an outside auditing firm or state auditors.

This EPA audit guide does not modify the auditor's responsibilities concerning reporting on irregularities, illegal acts or other material noncompliance. Auditors should follow *Government Auditing Standards* and published AICPA guidance if fraud, irregularities, illegal acts or other material noncompliance is discovered.

## **Appendix A**

### **Acronyms**

ACH	Automated Clearing House
AICPA	American Institute of Certified Public Accountants
CFDA	Catalog of Federal Domestic Assistance
CFR	Code of Federal Regulations
EPA	Environmental Protection Agency
FASB	Financial Accounting Standards Board
GAAP	Generally Accepted Accounting Principles
GAAS	Generally Accepted Auditing Standards
GAGAS	Generally Accepted Government Auditing Standards
GAO	General Accounting Office
GASB	Governmental Accounting Standards Board
IUP	Intended Use Plan
NCGA	National Council of Governmental Accounting
OA	Operating Agreement
OIG	Office of Inspector General
OIGA	Office of the Inspector General for Audits
OMB	Office of Management and Budgets
SAS	AICPA Statement of Auditing Standards
SRF	State Revolving Funds
The Act	Title VI of the Clean Water Act of 1987

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## **Appendix B**

### **Reference Material**

#### **SRF Program**

Clean Water Act (Title VI), as amended by the Water Quality Act of 1987.

40 CFR Part 35, Subpart K - State Water Pollution Control Revolving Funds

EPA's Initial Guidance for State Revolving Funds, January 1988

SRF Correspondence<sup>5</sup>

#### **Professional Audit Pronouncements**

Government Auditing Standards, 1994 Revision, by the Comptroller General of the United States

Pronouncements by the AICPA, Financial Standards Board

Pronouncements by the Governmental Accounting Standards Board

AICPA Audit and Accounting Guide, Audits of State and Local Governments, May 1, 1996

AICPA Audit and Accounting Guide, Consideration of Internal Control in a Financial Statement Audit, April 1, 1996

#### **Other Reference Material**

Single Audit Act, as amended July 5, 1996

OMB Circular No. A-133, effective July 1, 1996

OMB Circular No. A-133 Compliance Supplement (Provisional), June 1997

OMB Circular No. A-133 Compliance Supplement, May 1998

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EPA's Office of Water has compiled a listing of correspondence relevant to the SRF. Auditors should contact the SRF Coordinator in their region to obtain the listing and the desired correspondence.

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## **Appendix C**

### **Sample Engagement Letter**

Date

Addressee

Re: Audit of Financial Statements of State Revolving Fund

Dear :

This is to confirm our arrangements for the Office of the Inspector General to conduct an audit of the financial statements of the **[name of state]** State Revolving Fund (SRF) as of **[balance sheet date]**. The purpose of our examination is to:

- Express an opinion on the fairness of the financial statements prepared by the State of **[name of state]**, and to conclude whether such statements are prepared in accordance with generally accepted accounting principles;
- Report on the internal controls related to the financial statements of the SRF. The report will describes the scope of testing of the internal controls, the results of those tests, and if applicable, refer to a separate schedule of findings and/or costs questioned; and
- Report on compliance with an opinion as to whether the state has complied, in all material respects, with laws, regulations, and provisions of the SRF capitalization grants.

Our audit will be made in accordance with generally accepted government auditing standards and will include tests of your accounting records and other procedures we consider necessary to enable us to express an opinion that the financial statements of the State Revolving Fund are fairly presented, in all material respects. Our procedures will include tests of documentary evidence supporting the transactions recorded in the accounts, direct confirmation of cash balances, loans receivable and certain other assets and liabilities with selected communities or districts, and other parties as necessary. We will also request written representations from you about the financial statements and related matters.

We understand that you will provide us with basic information required for us to conduct our audit, and that you are responsible for the accuracy and completeness of that information. We will advise you about appropriate accounting principles, their application, and the preparation of your financial statements, but the responsibility for the financial statements is with the State of **[name of state]**.

As discussed with you, we will start our examination on **[date]**. In order to facilitate the examination, we would appreciate it if you could have certain information and schedules available prior to our arrival. Specifically, we will require:

- Financial statements for the SRF as of **[balance sheet date]**, a trial balance and chart of accounts;
- A detailed schedule of existing loans at **[balance sheet date]**, including dates of loans, original loan balance, loan balance at **[balance sheet date]**, repayment terms, and interest rates;
- A schedule of binding commitments made as of **[balance sheet date]**;
- Copies of the state legislation establishing the SRF, operating agreements, memorandums of understanding with other departments or agencies;
- Copies of all capitalization grant agreements, including amendments, awarded by the Environmental Protection Agency through **[balance sheet date]**;
- Access to minutes of the Board; and
- An organization chart of the SRF, and job descriptions for all personnel.

We will also require your assistance in preparing several letters and other correspondence related to the engagement.

If you should have any questions, please contact me at **[telephone number]**.

Sincerely,

Audit Manager/Team Leader

cc: Divisional Inspector General for Audits

## **Appendix D**

### **Financial Statement Assertions and Potential Misstatements**

This appendix is provided to identify each financial statement assertion, and the potential misstatements that could occur in each assertion in an accounting application. Specific control objectives are also presented to assist in assessing the control risk associated with each assertion. This information should be tailored to the specific state and accounting application, and can be supplemented with other control objectives as the situation dictates. This section is provided only as a reference to assist auditors in reviewing and assessing the internal controls over the SRF.

ASSERTION	POTENTIAL MISSTATEMENT	CONTROL OBJECTIVE
Existence or Occurrence	<p><b><u>Transaction-Related</u></b></p> <p><b>Validity:</b> 1. Recorded transactions do not represent economic events that actually occurred.</p> <p>2. Transactions are recorded in the current period, but the related economic events occurred in a different period.</p> <p><b>Summarization:</b> 3. Transactions are summarized improperly, resulting in an overstated total.</p>	<p>1a. Recorded transactions, underlying events, and related processing procedures should be authorized by federal laws, regulations, and management policy.</p> <p>1b. Recorded transactions should be approved by appropriate individuals in accordance with management's general or specific criteria.</p> <p>1c. Recorded transactions should represent events that actually occurred and should be properly classified.</p> <p>2. Transactions recorded in the current period should represent economic events that occurred during the current period.</p> <p>3. The summarization of recorded transactions should not be overstated</p>
	<p><b><u>Line Item/Account-Related</u></b></p> <p><b>Substantiation:</b> 4. Recorded assets and liabilities do not exist at a given date</p>	<p>4a. Recorded assets and liabilities should exist at a given date.</p> <p>4b. Recorded assets and liabilities of the entity, at a given date, should be supported by appropriate detailed records which are accurately summarized and reconciled to the account balance.</p> <p>4c. Access to assets, critical forms, records, and processing and storage areas should be permitted only in accordance with laws, regulations, and management policy.</p>

<b>ASSERTION</b>	<b>POTENTIAL MISSTATEMENT</b>	<b>CONTROL OBJECTIVE</b>
<b>Completeness</b>	<p><b><u>Transaction-Related</u></b></p> <p><b>Transaction Completeness:</b> 5. Valid transactions are not recorded.</p> <p><b>Cutoff:</b> 6. Economic events occur in the current period, but the related transactions are recorded in a different period.</p> <p><b>Summarization:</b> 7. Transactions are summarized improperly, resulting in an understated total.</p> <p><b><u>Line Item/Account-Related</u></b></p> <p><b>Account Completeness:</b> 8. Assets and liabilities of the entity exist but are omitted from the financial statements.</p>	<p>5. All valid transactions should be recorded and properly classified</p> <p>6. All economic events that occurred in the current period should be recorded in the current period.</p> <p>7. The summarization of recorded transactions should not be understated.</p> <p>8. All accounts that belong in the financial statements should be so included. There should be no undisclosed assets or liabilities.</p>
<b>Valuation or Allocation</b>	<p><b><u>Transaction-Related</u></b></p> <p><b>Accuracy:</b> 9. Transactions are recorded at incorrect amounts.</p> <p><b><u>Line Item/Account-Related</u></b></p> <p><b>Valuation:</b> 10. Assets and liabilities included in the financial statements are valued on an inappropriate basis.</p> <p><b>Measurement:</b> 11. Revenues and expenses included in the financial statements are measured improperly.</p>	<p>9. Transactions should be recorded at correct amounts.</p> <p>10. Assets and liabilities included in the financial statements should be valued on an appropriate valuation basis.</p> <p>11. Revenues and expenses included in the financial statements should be properly measured.</p>

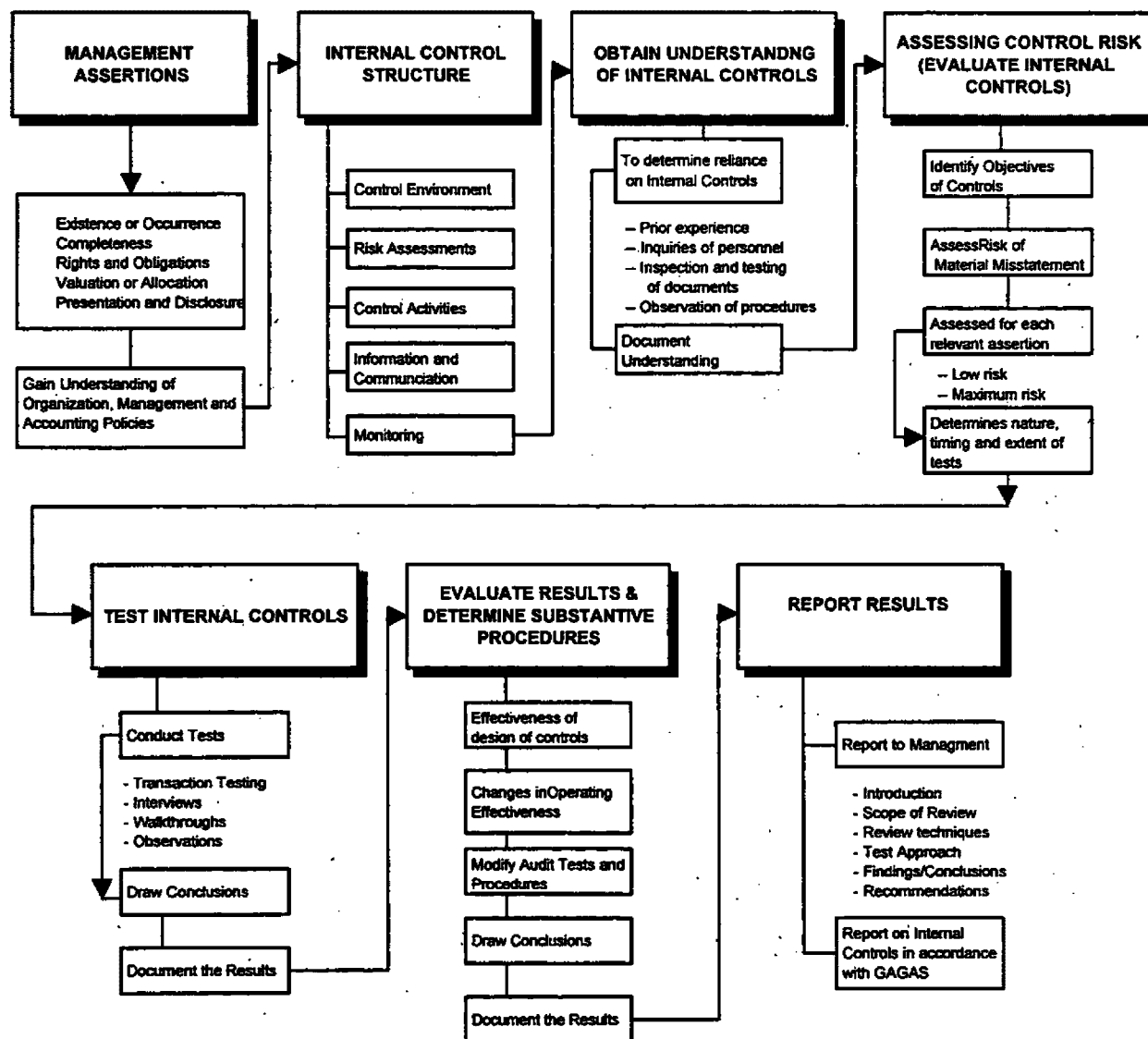
<b>ASSERTION</b>	<b>POTENTIAL MISSTATEMENT</b>	<b>CONTROL OBJECTIVE</b>
<b>Rights and Obligations</b>	<p><u>Line Item/Account-Related</u></p> <p><b>Ownership:</b> 12. Recorded assets are owned by others because of sale, consignment, or other contractual arrangements.</p> <p><b>Rights:</b> 13. The entity does not have certain rights to recorded assets because of liens, pledges, or other restrictions.</p> <p><b>Obligations:</b> 14. The entity does not have an obligation for recorded liabilities at a given date.</p>	<p>12. Recorded assets should be owned by the entity.</p> <p>13. Assets should be the entity's rights at a given date.</p> <p>14. Liabilities should be the entity's obligations at a given date.</p>
<b>Presentation and Disclosure</b>	<p><u>Line Item/Account-Related</u></p> <p><b>Account Classification:</b> 15. Accounts are not properly classified and described in the financial statements.</p> <p><b>Consistency:</b> 16. The financial statement components are based on accounting principles different from those used in prior periods.</p> <p><b>Disclosure:</b> 17. Required information is not disclosed in the financial statements or in the footnotes thereto.</p>	<p>15. Accounts should be properly classified and described in the financial statements.</p> <p>16. The financial statement components should be based on accounting principles that are applied consistently from period to period.</p> <p>17. The financial statements or footnotes thereto should contain all information required to be disclosed</p>
<b>See Note Below</b>	<p><u>Transaction-Related</u></p> <p><b>Segregation of Duties:</b> 18. The entity is exposed to loss of assets and various potential misstatements, including certain of those above, as the result of inadequate segregation of duties.</p>	<p>18. Persons should be prevented from having uncontrolled access to both assets and records.</p>

**Note:** Segregation-of-duties controls are a type of safeguarding control and are often crucial to the effectiveness of controls, particularly over liquid or readily marketable assets that are highly susceptible to theft, loss, or misappropriation. Such controls are designed to reduce the opportunities for any person to be in a position to both perpetrate and conceal errors or irregularities. The lack of segregation-of-duties controls may be pervasive and affect several misstatements.

## Appendix E

### Internal Control Review Process

The attached flowchart identifies the processes discussed in the SRF Audit Guide,



Planning and Internal Controls, in reviewing and reporting on internal controls in a financial statement audit.

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## Appendix F

### Sample Representation Letter

(On auditee letterhead)

[Date of Audit Report]

To the Office of the Inspector General  
Environmental Protection Agency

In connection with your audit of the balance sheet and the related statements of revenues, expenses and changes in fund balance, and cash flows of the State of [name of state] Revolving Fund, as of [balance sheet date], for the year then ended, for the purpose of expressing an opinion as to whether the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the State of [name of state] Revolving Fund in conformity with generally accepted accounting principles, we confirm, to the best of our knowledge and belief, the following representations made to you during your audit.

1. We are responsible for the fair presentation in the financial statements of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.
2. We have made available to you all:
  - a. Financial records and related data.
  - b. Minutes of the meetings of the [Governing Board] of the State Revolving Fund.
3. There have been no:
  - a. Irregularities involving management or employees who have significant roles in the internal control structure.
  - b. Irregularities involving other employees that could have a material effect on the financial statements.
  - c. Communications from regulatory agencies concerning noncompliance with, or deficiencies in, financial reporting practices that could have a material effect on the financial statements.
4. We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.

5. There are no related party transactions or related amounts receivable with the State of **[name of state]** Revolving Fund management or the **[Governing Board]** members.
6. Arrangements with financial institutions involving compensating balances or other arrangements involving restrictions on cash balances have been properly disclosed in the financial statements.
7. There are no:
  - a. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.
  - b. Other material liabilities or gain or loss contingencies that are required to be accrued or disclosed by Statement of Financial Accounting Standards No.5.
8. There are no unasserted claims or assessments that our counsel has advised us are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No. 5.
9. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.
10. We have complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.
11. No events have occurred subsequent to the balance sheet date that would require adjustment to, or disclosure in, the financial statements.

**Signatures**

**Chief Executive Officer**

**Chief Financial Officer**

**Appendix G**

**Sample Auditor's Report and Financial Statements**

**Sample State**  
**Water Pollution Control Revolving Fund**

***Financial Statements with  
Independent Auditor's Report***

***September 30, 1997***

***Audit Report No. E2HTL7-XX-XXXX***

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**Sample State  
Water Pollution Control Revolving Fund**

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## **Independent Auditor's Report**

### **Sample State Water Pollution Control Board**

We have examined the accompanying balance sheet of the Sample State Water Pollution Control Revolving Fund as of September 30, 1997, and the related statements of revenues, expenses and changes in retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on these financial statements based on our audit.

Except as discussed in the following paragraph, we conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

This was our first audit of the Fund's financial statements, and the scope of our examination did not include an audit of the financial statements of the preceding year sufficient to enable us to express, and we do not express, an opinion on the balance sheet of the Fund as of September 30, 1996 or the related statements of revenue, expenses and changes in retained earnings, and cash flows for the year then ended, nor do we express an opinion on the consistency of application of accounting principles with the preceding year.

In our opinion, the financial statements referred to in the first paragraph present fairly, in all material respects, the financial position of the Sample State Water Pollution Control Revolving Fund as of September 30, 1997 and the results of its operation and its cash flows for the year then ended in conformity with generally accepted accounting principles.

As discussed in Note 1, the financial statements referred to above are intended to present the financial position and results of operations of the Sample State Water Pollution Control Revolving Fund, a component of the Sample State. These statements are not intended to present the financial position or results of operations for the Sample State or the State Department of the Environmental, of which the Sample State Water Pollution Control Revolving Fund is a part.

In accordance with *Government Auditing Standards*, we have also issued a report dated December 11, 1997, on our consideration of the Sample State Water Pollution Control Revolving Fund's internal control structure and a report dated December 11, 1997 on its compliance with laws and regulations.

**[Audit Organization Name & Address]**

**[Date]**

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**Sample State  
WATER POLLUTION CONTROL REVOLVING FUND**

**Balance Sheet  
September 30, 1997  
With Unaudited Comparative Totals for 1996  
(in thousands)**

<u>Assets</u>	<u>1997</u>	<u>Unaudited 1996</u>
Current Assets:		
Cash and cash equivalents	\$ 101,082	\$ 67,701
Receivables:		
Interest on loans	2,693	2,284
Interest on investments	1,254	997
Other	<u>1,206</u>	<u>3,364</u>
Total receivables	5,153	6,645
Current maturities of loans receivable	<u>16,238</u>	<u>14,378</u>
Total current assets	<u>122,473</u>	<u>88,724</u>
Loans receivable, net of origination fees and current maturities	<u>410,834</u>	<u>345,031</u>
Total assets	<u>\$ 533,307</u>	<u>\$ 433,755</u>
 <u>Liabilities and Fund Equity</u>		
Current liabilities:		
Accounts payable and accrued expenses	\$ 184	\$ 222
Construction costs payable	516	4,414
Other	<u>18</u>	<u>30</u>
Total current liabilities	<u>718</u>	<u>4,666</u>
Fund equity:		
Contributed capital:		
Environmental Protection Agency	404,408	322,701
Sample State	91,947	83,946
Retained earnings	<u>36,234</u>	<u>22,442</u>
Total equity	<u>532,589</u>	<u>429,089</u>
Total liabilities and fund equity	<u>\$ 533,307</u>	<u>\$ 433,755</u>

The accompanying notes are an integral part of the financial statements.

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**Sample State  
WATER POLLUTION CONTROL REVOLVING FUND**

**Statement of Revenues, Expenses and Changes in Retained Earnings  
For the year ended September 30, 1997  
With Unaudited Comparative Totals for 1996  
(in thousands)**

	<u>1997</u>	<u>Unaudited 1996</u>
<b>Revenues:</b>		
Interest on loans	\$ 11,943	\$ 8,423
Investment income	<u>4,513</u>	<u>2,951</u>
Total revenues	16,456	11,374
<b>Expenses:</b>		
Administrative expenses	<u>2,664</u>	<u>2,637</u>
Revenues over expenses	13,792	8,737
Retained earnings, beginning of year	<u>22,442</u>	<u>13,705</u>
Retained earnings, end of year	<u>\$ 36,234</u>	<u>\$ 22,442</u>

The accompanying notes are an integral part of the financial statements.

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**Sample State**  
**WATER POLLUTION CONTROL REVOLVING FUND**

**Statement of Cash Flows**  
**For the year ended September 30, 1997**  
**With Unaudited Comparative Totals for 1996**  
(in thousands)

	<u>1997</u>	<u>Unaudited 1996</u>
Cash flows from operating activities:		
Revenues over expenses	\$ 13,792	\$ 8,737
Adjustments to reconcile operating income to net cash flow provided by operating activities:		
Amortization of loan fees	(48)	
Changes in assets and liabilities:		
(Increase) Decrease in receivables	1,492	(3,975)
Increase (Decrease) in accounts payable and accrued expenses	<u>(3,948)</u>	<u>(30)</u>
Net cash provided by operating activities	<u>11,288</u>	<u>4,732</u>
Cash flows from capital and related financing activities:		
Funds received from Environmental Protection Agency	81,707	73,686
Funds received from the Sample State	8,001	22,148
Contribution of state matching funds from local agencies	<u>1,584</u>	<u></u>
Net cash provided by capital and related financing activities	<u>91,292</u>	<u>95,834</u>
Cash flows from investing activities:		
Loan disbursements	(83,577)	(87,218)
Repayments on loans receivables	<u>14,378</u>	<u>11,116</u>
Net cash used in investing activities	<u>(69,199)</u>	<u>(76,102)</u>
Increase in cash and cash equivalents	33,381	24,464
Cash and cash equivalents, beginning of year	<u>67,701</u>	<u>43,237</u>
Cash and cash equivalents, end of year	<u>\$ 101,082</u>	<u>\$ 67,701</u>

The accompanying notes are an integral part of the financial statements.

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**Sample State**  
**WATER POLLUTION CONTROL REVOLVING FUND**  
**Notes to Financial Statements**  
**September 30, 1997**  
(In thousands)

**1. Organization of the Fund**

The Sample State Water Pollution Control Revolving Fund (the Fund) was established pursuant to Title VI of the Federal Water Quality Act of 1987 (the Act). The Act established the state revolving fund (SRF) program to replace the construction grants program to provide loans at reduced interest rates to finance the construction of publicly owned water pollution control facilities, nonpoint source pollution control projects, and estuary management plans. Instead of making grants to communities that pay for a portion of building wastewater treatment facilities, the SRF provides for low interest rate loans to finance the entire cost of qualified projects. The SRF provides a flexible financing source that can be used for a variety of pollution control projects, including non-point source pollution control projects, and developing estuary conservation and management plans. Loans made by the Fund must be repaid within 20 years, and all repayments, including interest and principal, must remain in the Fund.

The Fund was capitalized by the U.S. Environmental Protection Agency (EPA) by a series of grants starting in 1989. States are required to provide an additional 20 percent of the Federal capitalization grant as matching funds in order to receive a grant. As of September 30, 1997, Congress authorized the EPA to award \$627,041 in capitalization grants to Sample State (the State). The State is required to contribute \$125,408 in matching funds.

The Fund is administered by the Sample State Department of Environmental Protection (SDEP) through the Division of Clean Water Programs of the State Water Resources Control Board (the Board). SDEP's primary activities with regard to the SRF include the making of loans for water pollution control facilities, and the management and coordination of the Fund. The Board consists of five members, all of which are appointed by the Governor.

The Fund does not have any full time employees. Instead, SDEP charges the Fund for time spent on SRF activities by employees of the Board, and the Fund reimburses the State General Fund for such costs in the following month. The charges include the salaries and benefits of the employees, as well as indirect costs allocated to the Fund based on direct salary costs. Employees charging time to the Fund are covered by the benefits of the State. The Fund is also charged indirect costs of the State through the cost allocation plan for general state expenses.

The Fund is included in the State's general purpose financial statements as a Special Revenue Fund using the modified accrual basis. Because of the different presentation, there may be differences between the amounts reported in these financial statements and the general purpose financial statements.

**Sample State**  
**WATER POLLUTION CONTROL REVOLVING FUND**  
**Notes to Financial Statements**  
**September 30, 1997**  
(In thousands)

**2. Summary of Significant Accounting Policies**

***Basis of Accounting***

The Fund presents its financial statements as a nonexpendable trust fund. The Fund uses the accrual method of accounting whereby revenues are recorded as earned and expenses are recorded when the liability is incurred. The State has elected to follow the accounting pronouncements of the Governmental Accounting Standards Board (GASB), as well as statements issued by the Financial Accounting Standards Board before November 30, 1989 unless the pronouncements conflict with or contradict GASB pronouncements.

***Cash and Cash Equivalents***

All moneys of the Fund are deposited with the State Treasurer's Office, and are considered cash. According to State law, the Treasurer is responsible for maintaining the cash balances and investing excess cash of the Fund, as discussed in Note 3. Therefore, management of the Fund does not have any control over the investment of excess cash, and the statement of cash flows considers all funds deposited with the Treasurer to be cash or cash equivalents, regardless of actual maturities of the underlying investments.

***Loans Receivable***

The State operates the Fund as a direct loan program, whereby loans made to communities are 83.3 percent funded by the Federal capitalization grant, and 16.7 percent by the state matching amount. Loan funds are disbursed to the local agencies as they expend funds for the purposes of the loan, and request reimbursement from the Fund. Interest is calculated from the date that funds are advanced, and after the final disbursement has been made, the payment schedule identified in the loan agreement is adjusted for the actual amounts disbursed, and interest accrued during the project period. No provision for uncollectible accounts has been made as all loans are current, and management believes that all loans will be repaid according to the loan terms.

***Contributed Capital***

In accordance with generally accepted accounting principles, funds received from the EPA and the State for the capitalization of the Fund are recorded as contributed capital. In certain cases, local communities have contributed the State's 20 percent match in exchange for zero interest rate loans. The state match made by local agencies has been recorded as a reduction in the loan receivable, and amortized to interest income over the life of the loan in accordance with the provisions of Financial Accounting Standards Board Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases, as further discussed in Notes 4 and 5.



**Sample State**  
**WATER POLLUTION CONTROL REVOLVING FUND**  
**Notes to Financial Statements**  
**September 30, 1997**  
(In thousands)

**2. Summary of Significant Accounting Policies (continued)**

***Budget Information***

Under the Sample State constitution, money may only be drawn from the Treasury by a legal appropriation. However, the Fund operates under a continuous appropriation because the funding of the matching funds approved by the voters contained its own appropriation authority. Therefore, the Fund operations are not included in the State's annual budget.

***Reclassifications***

Certain amounts in the 1996 unaudited financial statements have been reclassified to conform to the presentation in the 1997 financial statements.

**3. Cash and cash equivalents**

All monies of the Fund are deposited with the Treasurer, and are considered to be cash. The Treasurer is responsible for maintaining the cash balances in accordance with State laws, and excess cash is invested in the State's Surplus Money Investment Fund (SMIF), which is part of the Pooled Money Investment Account (PMIA). Details of the investments of the PMIA can be obtained from the State Treasurer. As of June 30, 1997, the latest date available, the State's total pooled investments were approximately \$26 billion, and the average remaining life of the securities invested was 291 days. The combined deposits of the SMIF as of June 30, 1997 was approximately \$12.1 billion, and total earnings for the year ended June 30, 1997 were approximately \$662 million.

All cash of the Fund is stated at cost. Investments in local government investment pools are not categorized because they are not evidenced by securities that exist in physical or book entry form. Details of invested funds at June 30, 1997 are:

	<u>Carrying Amount</u>	<u>Market Value</u>
Not subject to categorization:		
Local government investment pool	<u>\$ 101.082</u>	<u>\$ 101.082</u>

**4. Loans Receivable**

The Fund makes loans to qualified agencies for projects that meet the eligibility requirements of the Act. Loans are financed by capitalization grants, state match, local contributions, and revolving funds. Effective interest rates on loans vary between 1.8 percent and 4.0 percent, and are generally repaid over 20 years starting one year after the project is completed. Details of loans receivable as of September 30, 1997 are:

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**4. Loans Receivable (continued)**

***Loans by Category:***

Loans receivable at September 30, 1997, net of loan origination fees, as discussed below, are as follows:

	<u>Loan Authorized</u>	<u>Remaining Commitment</u>	<u>Balance</u>
Completed projects	\$ 280,423	\$ 0	\$ 224,290
Projects in progress	<u>298,204</u>	<u>94,059</u>	<u>202,782</u>
Totals	<u>\$ 578,627</u>	<u>\$ 94,059</u>	427,072
Less amount due within one year			<u>16,238</u>
Loans receivable, net, September 30, 1997			<u>\$ 410,834</u>

Loans mature at various intervals through September 30, 2016. The scheduled principle payments on loans maturing in subsequent years are as follows:

<u>Year ending September 30:</u>	<u>Amount</u>
1998	\$ 16,238
1999	22,199
2000	25,082
2001	27,442
2002	28,270
Thereafter	<u>307,841</u>
	<u>\$ 427,072</u>

***Loan Origination Fees:***

Beginning in 1997, the Fund offered local agencies the option of receiving zero-interest rate loans (zero-rate loans). In order to obtain a zero-rate loan, the agency had to pay the State's matching share of the loan, generally 16.7 percent of the total loan amount. EPA considers the amounts paid by local agencies as meeting The State's matching requirement. However, Financial Accounting Standards Board Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Direct Initial Costs of Leases (FASB No. 91), states that fees that reduce the loan's interest rate are considered origination fees, and requires that loan origination fees be deferred and recognized over the life of the loan as an adjustment to the interest rate. FASB 91 also requires that the unamortized balance of such fees be reported as part of the loan to which it relates.

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**4. Loans Receivable (continued)**

As of September 30, 1997, seven agencies entered into agreements for zero-rate loans for \$16,271, which includes total matching funds of \$2,712 to be contributed by the local agencies. At the balance sheet date, the local agencies had provided \$1,584 in matching funds on loans disbursed as of that date. Details of the loans are:

	Loan Amount Authorized	Funds Disbursed	Unamortized Loan Origination Fee	Loan Balance
Completed projects	\$ 3,869	\$ 3,869	\$ 595	\$ 3,274
Projects in progress	12,402	4,956	941	4,015
Totals	<u>\$ 16,271</u>	<u>\$ 8,825</u>	<u>\$ 1,536</u>	<u>\$ 7,289</u>

Amortization of loan origination fees on completed projects was \$48 for the year ended September 30, 1997.

**Loans to Major Local Agencies**

As of September 30, 1997, the Fund had made loans to eleven agencies that, in the aggregate, exceeded \$10 million. The outstanding balances of these loans represents approximately 81 percent of the total loans receivable, as follows:

Local Agency	Authorized Loan Amount	Outstanding Balance
City & County of San Angelo	\$ 136,316	\$ 108,469
Los Pablo County	63,711	52,090
Western Utility District	60,360	51,932
Santana Water Authority	43,933	42,087
City of Bear River	29,007	21,094
Miller's Valley Sewer District	18,736	15,856
Union Valley Sanitation District	18,000	16,376
City of Independence	15,991	13,422
High Water Flood Control District	12,142	9,862
City of Gainesville	11,675	7,624
Moose Jaw Sanitary District	11,305	8,191
Total	<u>\$ 421,176</u>	<u>\$ 347,003</u>

The authorized loan amount includes both completed projects and projects in progress. As of September 30, 1997, principal repayments on completed projects to the above agencies was \$42,826 and remaining amounts to be disbursed on projects in progress was \$30,774.

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**5. Contributed Capital and Fund Balance**

The Fund is capitalized by grants from EPA authorized by Title VI of the Act, matching funds from the State, and contributions by certain local agencies. All funds drawn are recorded as contributed capital from the Environmental Protection Agency and Sample State. As of September 30, 1997, EPA has awarded capitalization grants of \$627,041 to the State, of which \$404,408 has been drawn for loans and administrative expenses. The State has provided matching funds of \$91,947. The following summarizes the capitalization grant awarded, amounts drawn on each grant as of the balance sheet date, and balances available for future loans:

Year	Grant Amount	Total Draws September 30, 1996	1997 Draws	Total Draws September 30, 1997	Available September 30, 1997
1989	\$ 76,547	\$ 76,496	\$ 18	\$ 76,514	\$ 33
1990	71,866	69,501	945	70,446	1,420
1991	88,067	82,706	3,901	86,607	1,460
1992	83,377	64,930	15,970	80,900	2,477
1993	82,479	27,675	23,393	51,068	31,411
1994	51,177	1,393	25,299	26,692	24,485
1995	52,855	0	7,181	7,181	45,674
1996	86,578	0	5,000	5,000	81,578
1997	34,095	0	0	0	34,095
Totals	<u>\$ 627,041</u>	<u>\$ 322,701</u>	<u>\$ 81,707</u>	<u>\$ 404,408</u>	<u>\$ 222,633</u>

As of September 30, 1996 and 1997, State matching contributions were:

	September 30, 1996	1997 Contribution	September 30, 1997
Sample State	<u>\$ 83,946</u>	<u>\$ 8,001</u>	<u>\$ 91,947</u>

As discussed in Note 4, certain local agencies provided the State's 20 percent match in exchange for zero interest loans. As of September 30, 1997, the amount contributed by local agencies was \$1,584. The EPA considers the local agency contributions as part of the State's 20 percent matching funds. However, according to generally accepted accounting principles, the amounts are not included as part of the State's contributed capital in these financial statements.

**6. Contingencies and Subsequent Events**

**Contingencies**

The Fund is exposed to various risks of loss related to torts, thefts of assets, errors or omissions, injuries to state employees while performing Fund business, or acts of God.

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**6. Contingencies and Subsequent Events (continued)**

The Fund maintains insurance for all risks of loss which is included in the indirect costs charged to the Fund. There have not been any claims against the Fund since its inception in 1989.

***Subsequent events***

Subsequent to year end, the EPA awarded the 1998 capitalization grant to the State. The grant provides \$53,489 in additional funds, including the State matching share of \$8,915, for making loans to qualified communities.

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