

# THE DWSRF GUIDE TO UNDERSTANDING AUDITS



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# Table of Contents

<b>Introduction: What is an Audit?</b>	1
<b>Chapter 1: State Revolving Fund Audits</b>	3
<b>Chapter 2: The SRF Audit Process</b>	6
<b>Chapter 3: The DWSRF Audit Report</b>	10
<b>Findings and Recommendations</b>	20
<b>Appendix A</b>	23
Sample Audit Engagement Letter	
Required Assistance from Program Personnel	
<b>Appendix B</b>	29
Sample Management Representation Letter	
<b>Appendix C</b>	34
Single Audits	

**Introduction: What is an Audit?**

An audit is a series of procedures followed by an experienced professional accountant to test, on a selective basis, transactions and internal controls in effect, all with a view to forming an opinion on the fairness of the presentation of the financial statements [of an organization] for the period. (Gross and Warhauser 1983, 370)

Audits are undertaken to report on the financial performance of an organization, program, or function and to determine whether funds and property were properly used and distributed over the course of a year or other time period. They provide important information about an enterprise to regulatory agencies, financial markets, and the public. As the U.S. Comptroller General notes in his introductory letter to the 2003 Revision of *Government Auditing Standards*, "Auditing allows those parties [legislators, government officials, and the public] and other stakeholders to have confidence in the reported information on the results of programs or operations, as well as in the related systems of internal control."

An audit is a joint undertaking between the audited organization and the auditor(s). If both parties work together, audits can provide a foundation from which the management team of the audited entity can work to make changes that increase efficiency and effectiveness to either address the concerns of the auditor or to meet the internal goals of the organization. "The audit process should be viewed as an opportunity for an objective, skilled, and impartial review of program operations, which can result in suggestions for improvement" (U.S. Department of Labor n.d., 6).

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The National Council of Governmental Accounting articulated the importance of financial reporting in its statement of goals by acknowledging that financial information, such as is found in audits, is not only useful for demonstrating accountability and stewardship, but also provides information useful for evaluating managerial and organizational performance and informing economic, political, and social decisions (U.S. Environmental Protection Agency 2001, 4–8).

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This guide is concerned with audits of Drinking Water State Revolving Fund (DWSRF) programs and the interpretation of the reports and financial statements that result from those audits. The goal of broad audits performed under the Single Audit Act, as amended, is an opinion (or disclaimer of opinion) on the financial statements of the entity being audited. The State Revolving Fund (SRF) program audit should include an opinion (or disclaimer) on whether the program's financial statements are presented fairly. Either way, the goal of the audit is to establish the reliability of the state program's financial statements. As a result, anyone using the financial statements in an analysis of program performance should know whether they can rely on the accuracy of those statements.

***Purpose of this Document***

The purpose of this document is to provide a reader-friendly “user’s guide” to understanding audit reports. It is intended to help EPA and state staff better understand and use the reports of DWSRF audits. The guide explains how to interpret an audit’s findings and how best to follow up on those findings.

## Chapter 1: State Revolving Fund Audits

EPA's role in the SRF program is one of oversight of the states. One of the best methods to assist in EPA's oversight role is to obtain annual financial statements from the states that have been audited. EPA uses the audited financial statements to determine if the program is operating as intended, and to gather information necessary to report to Congress (U.S. Environmental Protection Agency 2002, 2-1).

### *SRF Audit Objectives* (U.S. Environmental Protection Agency 2002)

The focus of the SRF audit is a state's SRF program, not the individual capitalization grants awarded to the state. The DWSRF program comprises the loan fund, any set-asides used by the state, administrative, or loan fee funds and other program income.

The objectives of SRF audits are to:

- Express an opinion on the fairness of the financial statements of the SRF programs and to conclude whether such statements are prepared in accordance with generally accepted accounting principles (GAAP).
- Report on the internal controls related to the SRF's financial statements. This report describes the scope of testing of the internal controls and the results of those tests. It also refers to a separate schedule of findings or costs questioned, if applicable.
- Report on the state's compliance with laws, regulations, and provisions of the SRF capitalization grants and other applicable federal laws that could have a direct and material effect on the financial statements.

SRF audits are to be conducted in accordance with generally accepted government auditing standards (GAGAS) set forth in the manual *Government Auditing Standards*. The audit process includes testing of accounting records and other procedures that the auditor considers necessary to express an opinion about whether the financial statements—in this case of the SRF—are presented fairly in all material respects. Audits also include tests of documentary evidence supporting the transactions recorded in the accounts and direct confirmation of cash balances, loans receivable, and other assets and liabilities with selected communities and other parties as necessary. The product of an SRF audit includes the following reports:

- Financial statements with an opinion (or disclaimer of opinion) about whether the SRF financial statements are presented fairly in all material respects and in conformity with GAAP. At a minimum, financial statements must include:

- A statement of net assets or balance sheet.
  - A statement of revenues, expenses, and changes in net assets.
  - A statement of cash flows.
  - Notes to the financial statements.
- A report on internal controls related to the SRF financial statements. The internal control system consists of policies and procedures established by the state to ensure that its assertions are valid (U.S. Environmental Protection Agency 2002, 5-1).
  - A report on compliance. Compliance with laws, regulations, and the provisions of SRF capitalization grants allows EPA to effectively have some assurance over items that it believes are important to the successful management of the program and legislative intent (U.S. Environmental Protection Agency 2002, 7-1).

### ***Types of SRF Audits***

EPA encourages states to have their SRF programs audited separately. However, a state may opt to include its SRF program in a single, statewide audit mandated by the Single Audit Act of 1984 and the Single Audit Act Amendments of 1996.

#### ***Single Audits***

A single audit is a rigorous, statewide review that has financial and compliance components. Single audits are the government's way of making sure that states, as recipients of major federal grants and other forms of financial support, are using the money properly and are adhering to a uniform set of accounting standards at an entity-wide level (Flood 2002).

A single audit covers a state's financial books of account, general management, and systems of internal control. It also includes a review of the federal assistance received by the state during the audited period. The financial review examines the books of account, financial statements, and general award transactions to determine whether they fairly and accurately describe the results of the state's operations in accordance with GAAP (Flood 2002).

Audits performed in compliance with the Single Audit Act rarely provide sufficient financial detail to evaluate the SRF program's financial condition, the results of its operations, and, therefore, its compliance with the perpetuity requirements of the Safe Drinking Water Act (SDWA). In other words, most state audits performed in compliance with the Single Audit Act will not qualify as SRF program-specific audits. For more information on single audits, see Appendix C.

*SRF Program Audits*

Audits of SRF programs provide more specific detail on program finances, internal controls, and compliance than do Single Audit Act audits. They may be performed by a state audit agency, an independent auditing firm hired by the state, or EPA Office of Inspector General (OIG) personnel. In any event, audits of SRF programs, at a minimum, should be conducted according to *Government Auditing Standards* (GAGAS, often called the Yellow Book). GAGAS requires, among other things, a report on the auditor's consideration of internal controls and compliance with applicable federal requirements over financial reporting; this report is not required under the American Institute of Certified Public Accountants' (AICPA's) GAAS. Because federal funds are part of SRF programs, audits conducted solely under GAAS do not meet the requirements of GAGAS (U.S. Environmental Protection Agency 2002a, 1-1).

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All DWSRF programs are independently audited periodically (regularly) in addition to any coverage by Single Audits. These Yellow Book audits of each state's financial statements are performed every 1-3 years. (The majority are done annually.) The audits are conducted by the EPA OIG, a state auditor, or an accounting firm hired by the state. For more information on OIG audits, go to <http://www.epa.gov/oig/reports/water.htm> or <http://www.epa.gov/oig/reports/grants.htm>

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GAGAS "are intended for use by government auditors to ensure that they maintain competence, integrity, objectivity, and independence in planning, conducting, and reporting their work ...." (U.S. General Accounting Office 2003, 5). These standards provide the fundamental requirements for ensuring that the results of an audit are credible. They cover a wide range of topics including the independence of the auditing organization and the individual auditor, the services the auditing organization and individual auditor should and should not provide, and the use of professional judgment.

GAGAS pertain to auditors' professional qualifications and the quality of their work, the performance of field work, and the characteristics of meaningful reporting. Adherence to GAGAS can help ensure that audits . . . provide credibility to the information reported or obtained by officials of the entity audited through objectively acquiring and evaluating evidence. When auditors perform their work in this manner and comply with GAGAS in reporting the results, their work can lead to improved government management, decision making, and oversight (U.S. General Accounting Office 2003, 5 and 6).



## **Chapter 2: The SRF Audit Process**

An audit is not an examination of every transaction that has been recorded; it is a series of tests designed to give the accountant a basis for judging how effective records were kept and the degree of reliance that can be placed on internal controls (Gross and Warhauser 1983, 370).

Audits of government entities, programs, activities, and functions, and audits of government assistance administered by contractors, nonprofit organizations, and other nongovernmental entities typically are conducted according to GAGAS. The steps typically followed in an SRF program audit are presented below.

### ***1. Notify the State Program***

This is usually the first step in the audit process. Most auditors will inform the state of their plans to conduct the audit prior to its scheduled start. Notification is generally given 6 to 9 months before the end of the audited state's fiscal year.

### ***2. Research State Program***

Before beginning their field work, the auditors will research the state DWSRF program by reviewing the materials provided by the state. These materials will include detailed general ledgers as of the end of the audit period, a schedule of cash balances as of the end of the audit period, and a detailed listing of outstanding loans as of the end of the audit period.

### ***3. Develop Tests***

As they prepare for the audit engagement, the auditors develop internal control tests that will help them understand the DWSRF program. This understanding includes the roles of program managers, the forms of program oversight used, and the inherent strengths and weaknesses of the controls used by the program. Internal control tests can disclose how closely the program keeps track of financial transactions and how many controls are in place to provide checks and balances on its accounting and reporting practices.

### ***4. Send Engagement Letter***

An audit engagement letter similar to the one found in Appendix A of this document is sent by the auditor to the SRF manager. In this letter, the auditor states the period that the audit will cover, its purpose, and the process to be followed. The letter also specifies what the auditor is responsible for (e.g., reviewing whether program financial statements are prepared according to GAAP) and what assistance the program will provide. This assistance includes:

- Financial statements and trial balances for the audit period.
- Detailed general ledgers that include beginning balances, transactions made during the year, and ending balances for all DWSRF accounts, including set-asides and administration fees.
- Detailed lists of loans outstanding at the beginning and end of the audit period that include the original loan amount, disbursements made and repayments received during the audit period, interest receivable at the beginning and end of the audit period, and interest and fee income earned during the year. The totals from this schedule should agree with the appropriate trial balance and general ledger account balances.
- A copy of the most recent Single Audit covering the DWSRF.

### ***5. Receive Information Requested***

Some of the information specified in the engagement letter is provided to the auditors before they begin their field work. Other information is given to them while they are on site.

### ***6. Hold Entrance Conference***

During this meeting, the auditors review with the State DWSRF program management the audit's purpose, scope and objectives, and schedule. The entrance conference allows the DWSRF program managers to bring any additional noteworthy items to the attention of the auditors.

The entrance conference and engagement letter provide an excellent opportunity for the DWSRF program managers and the auditors to understand everything that constitutes the DWSRF program, including set-asides and fees. They also detail what the auditors will be doing, what their responsibilities are, and what the responsibilities of program managers are as well.

### ***7. Conduct Fieldwork (Tests and Compliance Checks)***

Fieldwork includes time spent at the DWSRF program office to collect information from records, interview staff, and identify processes and habits. It provides auditors with additional background about the history of the program and its financial state. Fieldwork also gives the auditors information on which to base their conclusions about the state DWSRF program.

While in the field, the auditors conduct **internal control tests** of the DWSRF program. Internal control tests can disclose how closely the state keeps track of financial transactions and how many controls are in place to provide checks and balances on its accounting and reporting practices. If the auditors find that the internal controls are effective, the extent of the actual financial testing of records can be limited. If internal controls are not as strong as they should be,

auditors will conduct more extensive financial tests.

For DWSRF program audits, **compliance checks** are part of the auditor's fieldwork. The auditors check that the program meets all of the applicable federal and state requirements. For most programs, especially those under EPA guidance, the auditors follow guidelines that lay out carefully which regulations should be complied with depending on which program is being audited. This part of the audit can be very important, especially for state SRF programs.

Throughout the fieldwork process, auditors will be in touch with managers to inform them of the findings of the audit team. Management teams will be given a final opportunity to comment on the audit results in the exit conference after fieldwork has been concluded.

### ***8. Hold Exit Conference***

At the end of the audit fieldwork, the auditors hold an **exit conference** with the DWSRF program's management team. The auditors present their findings and receive feedback. The exit conference is an opportunity for auditors to "advise management regarding matters observed during the audit that could improve internal controls or efficiency, effectiveness, and economy [of the program] . . . and procedures for resolving compliance issues or other matters" (U.S. Environmental Protection Agency 2002, 8-2). The exit conference should be a summary of previous discussions held with the management throughout the audit process.

### ***9. Receive Representation Letter***

After the exit conference, the auditors will receive from the DWSRF program managers a representation letter stating that no relevant information has been withheld from the auditors and that the information provided is a fair representation of the DWSRF program and how it is operated. An example of a management representation letter is provided in Appendix B.

### ***10. Submit Reports and Financial Statements to EPA***

Within a reasonable time period after the conclusion of the auditors' fieldwork, final audit reports and accompanying financial statements are submitted as a complete package to staff in the EPA Regional Office, who are responsible for following up with the state. (Recently, OIG has been sending directly to EPA its audit reports and the recommendations they contain. This change should help make clear EPA's existing responsibilities for following up on audit findings.)

### ***11. Negotiate Follow-up***

After the final audit report is submitted, the audited entity is given a set amount of time in which to respond to any findings and recommendations made by the auditors concerning necessary

changes in procedure or process. The “audit follow-up” consists of proposals from the audited entity’s management team regarding how to address the recommendations made by the auditors. These proposals generally include action items, completion dates, and other measures that ensure the proposals will be implemented and progress will be noted (Massachusetts Institute of Technology n.d.).

### ***12. Accept Follow-up***

The state and the Region’s response to the issues raised during the audit and reported in the final audit report must be acceptable to EPA in order to close out the audit.

### Chapter 3: The DWSRF Audit Report

The end product of the audit is not a “certificate” that every transaction has been properly recorded, but an expression of an opinion by the auditor on the fairness of the presentation of the financial statements [taken as a whole for each opinion unit] (Gross and Warhauser 1983, 370).

Like most audit reports, the report of a DWSRF program audit prepared in accordance with GAGAS includes an **auditor's standard report** on financial statements and management and a **report on compliance** with regulations and requirements. The auditor's standard report is issued only when the auditor has formed an opinion that the financial statements present fairly, in all material respects, the DWSRF program's financial position and the results of operations and cash flows in accordance with GAAP. Reports other than the standard report may be issued if explanatory language is needed, if the opinion is not unqualified, if an adverse opinion is provided, or if a disclaimer of opinion is expressed. (The report on compliance is commonly combined with a report on internal controls.)

These reports are written in the form of a letter, addressed to the head of the organization being audited. A standard audit report is typically followed by audited financial statements such as a balance sheet; a statement of revenues, expenses, and changes in net assets; and possibly a statement of cash flows, all with appropriate footnotes (see Appendix C for a primer on how to read these statements). Reports on internal control and compliance can be followed by sections on findings and recommendations and supplemental information. For SRF programs, reports on internal control and compliance, along with supplemental information about set-aside expenses and schedules of loan activities, are very important to create an overall picture of the program.

#### *Auditor's Standard Report*

The report is written in conformity with Statements on Auditing Standards (SAS) No. 58, Reports on Audited Financial Statements (AU 508), which was issued in 1988 and later amended. This report format is meant to make audit reports concise and easy to understand for all readers. Each paragraph of the report has a specific function, as explained below.

The AICPA has provided an example of an audit report in its Audit and Accounting Guide for State and Local Governments. The example, modified for an DWSRF program, might look like the following:

### Independent Auditor's Report

We have audited the accompanying financial statements of the Any State Drinking Water State Revolving Fund Program (the Program) as of and for the year ended June 30, 2004. These financial statements are the responsibility of the Program's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *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.

As discussed in Note 1, the financial statements referred to above are intended to present the financial position, and the changes in financial position and cash flows, where applicable, of the Program. They do not purport to, and do not, present fairly the financial position of Any State as of June 30, 2004, and the changes in its financial position and its cash flows, where applicable, for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Program, as of June 30, 2004, and the changes in financial position and cash flows, where applicable, thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Signature

Date

The first paragraph of an audit report is the **introductory paragraph**. It explains what entity is being audited, the financial statements being audited, the period covered by the audit, and the auditor's responsibility for the opinion being expressed. It also states that the management of the audited entity is responsible for any financials presented in the auditor's report.

A typical introductory paragraph can be found in the auditor's report for the South Carolina DWSRF Program as of June 30, 2002:

We have audited the accompanying balance sheet of the South Carolina Drinking Water State Revolving Fund Program (the Program) as of June 30, 2002, the related statement of revenues, expenses, and changes in fund equity [net assets], and the statement of cash flows for the year then ended. These financial statements are the responsibility of the Program's management. Our responsibility is to express an opinion on these financial statements based on our audit (Dayton 2003a, 1).

The second paragraph, generally referred to as the **scope paragraph**, explains that the audit was conducted in accordance with GAAS (or GAGAS in the case of government audits), that the evidence was examined on a test basis, and that the evaluation of the financial statements provides a reasonable basis for the auditors' opinions. This last statement explains that the auditors examined a reasonable amount of information, but not everything, and while they believe they have a solid foundation on which to state an opinion, the audit process is not foolproof.

Again, the report of the audit of the South Carolina DWSRF Program provides an example of a scope paragraph:

We conducted our audit in compliance with generally accepted auditing standards in the United States of America and Government Auditing Standards issued by the Comptroller General of the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free 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 (Dayton 2003a, 1).

The last paragraph is the **opinion paragraph**, in which the auditors express their opinion: unqualified, qualified, or adverse. Some audit reports have a few extra paragraphs that explain any materials or reports attached to the audit report or any qualifications of the auditor's opinions. Readers who are uncertain about what opinion is being expressed can look to other paragraphs to see if there are any qualifying statements (Woelfel 1994, 52). Most audits of a state SRF program will have additional language that has nothing to do with a qualified opinion. Instead, the reports include explanations of the supplemental information included, such as set-aside information or loan schedules.

Auditors usually issue an unqualified opinion. Occasionally, that opinion will have explanatory language attached to it, but it will still be considered unqualified. Qualified opinions and adverse

opinions are infrequent, but they do occur when departures from GAAP in financial statements that cannot be explained are found during the auditor's fieldwork. Rarely, an auditor will be unable to issue an opinion and will state as much in the audit report. These opinions or disclaimers are explained below.

### Unqualified Opinion

An **unqualified opinion**, like the one for the South Carolina DWSRF audit discussed above, is also known as a "clean opinion." It signifies that the auditor found no material discrepancies with the financial reports and internal controls of the audited entity.

An **unqualified opinion with explanatory language** is issued when an auditor is comfortable enough with the financial statements to issue a clean opinion but would like to emphasize or clarify matters. These can include any accounting methods that are inconsistent from one year to the next, whether the opinion is based in part on work done by another audit firm, limitations on the scope of the audit work, departures from GAAP/GAAS, or one of several other technical matters (Pany and Whittington 1994). Adding explanatory language is not considered a qualification because it does not lessen the auditor's reporting responsibility for the financial statements (Credit Research Foundation n.d.).

The Credit Research Foundation Web site provides an example of explanatory language related to the auditor's opinion that a company may not continue as an ongoing concern. Although this concern is unlikely to arise as the result of a DWSRF audit, the example does give an idea of how an auditor's concerns may be presented in an audit report. The report is modified by adding a paragraph such as:

The accompanying financial statements have been prepared assuming that ABC Company will continue as a going concern. As discussed in Note 1 to the financial statements, ABC Company has suffered recurring losses from operations and has a net capital deficiency that raises substantial doubt about the entity's ability to continue as a going concern. Management's plan in regard to these matters are also described in Note 1. The financial statements do not include any adjustments that might result from the outcome of this uncertainty (Credit Research Foundation n.d.).

### Qualified Opinion

A **qualified opinion** shows the next level of concern that auditors can exhibit in their report. An auditor issues a qualified opinion when there has been a material departure from GAAP, but the departure(s) does not affect the overall fairness of the financial reports. Issues that could force auditors to declare a qualified opinion include situations in which a component or components of the financial statements did not follow GAAP and limitations in the scope of the audit.

According to Wyett (2000), circumstances that could give rise to a qualified opinion include:



- **Uncertainty** arising from either a limitation on the scope of the auditors' work or an inability to obtain any evidence regarding doubts that exist in relation to an unresolved matter.
- **Disagreements** arising from factual discrepancies, unsuitable accounting policies, inadequate or misleading disclosures given in the financial statements, or failure to comply with an accounting standard or legislation. Some types of disagreements should be resolved fairly easily with the audited entity's management so that a qualification can be avoided. Other types of disagreements, which may be subjective, may be more difficult to resolve. An example of such a disagreement is one relating to the suitability of an accounting policy.

The effects of these circumstances can be classified as:

- A material,<sup>1</sup> but not fundamental,<sup>2</sup> effect on the financial statements.
- A fundamental effect on the financial statements.

The exact wording of the qualified opinion will depend, of course, on the nature of the circumstances that give rise to the opinion in the first place.

#### Adverse Opinion

An **adverse opinion** means the auditors do not believe that the financial statements, when taken as a whole, present fairly the financial position, change in financial position, or cash flow of the program. An adverse opinion indicates a significant problem with the way the audited entity

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<sup>1</sup>The concept of materiality recognizes that some matters are important for the financial statements to be presented fairly, in accordance with GAAP, while others are not. Financial statements are materially misstated when the effects of the item (or items) cause the financial statements to not be fairly presented and would probably lead someone relying on the financial information to make a different conclusion than if the statements were not misstated. Misstatements can occur because of errors, a failure to apply accepted accounting principles, departures from fact, or omissions of necessary information.

Determining what is material is a matter of professional judgment 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 (U.S. Environmental Protection Agency 2002).

<sup>2</sup>"Fundamental" means the matter seriously distorts or undermines the view that is given by the financial statements to the extent that it could mislead user groups.

reports its financial statements, and it can severely affect investments in or public approval of the program. Adverse opinions can indicate that an entity is not following established financial reporting standards and generally accepted accounting principles. Adverse opinions in DWSRF program audit reports are unlikely.

#### Disclaimer of Opinion

Auditors can also issue a **disclaimer of opinion**, which means they will not issue an opinion on the financial reports. Disclaimers generally are issued only when the scope of the auditor's examination of the financial reports has been limited to such an extent that the auditor has performed an audit insufficient in scope to issue an opinion on the financial statements. As with adverse opinions, disclaimers relating to DWSRF program audits are unlikely.

The following table (based on Kell and Boynton 1980, 33) illustrates the circumstances under which auditors will issue specific opinions outside of the standard report's unqualified opinion.

#### Example

The audit of the South Carolina DWSRF Program resulted in an unqualified opinion:

In our opinion, the financial statements referred to in the first paragraph represent fairly, in all material respects, the financial position of the Program as of June 30, 2002, and the results of its activities and its cash flows for the year then ended in conformity with generally accepted accounting principles in the United States of America (Dayton 2003a, 1).

Circumstance	Standard Report	Departures from Standard Report			
		Standard Report with Explanatory Language	Other Types of Opinions		
	<i>Unqualified Opinion</i>	<i>Unqualified Opinion</i>	<i>Qualified</i>	<i>Adverse</i>	<i>Disclaimer</i>
Audit completed in accordance with GAAS/GAGAS, financial statements conform to GAAP, and:  - Circumstances requiring explanatory language do not exist	✓				
- Circumstances requiring explanatory language do exist		✓			
Financial statements contain a departure from GAAP			✓ Material	✓ Extremely Material	
Auditor unable to obtain sufficient competent evidence (scope limitation)			✓ Material		✓ Extremely Material

*Financial Reports*

The **balance sheet** (also known as the “Statement of Net Assets”) is the first of three financial statements typically included with an audit report. It shows assets and liabilities. “The balance sheet is considered to be a statement of the ‘financial position’ of the enterprise on the date noted in the heading of the statement” (Dixon and Arnett 1993, 2). The balance sheet, however, does not provide any information on how the organization got to that financial position or the direction its financial position is headed. It is worth remembering that the balance sheet of a DWSRF program shows the program’s liabilities (including bond interest payable and bonds payable) and its net assets *at a single point in time*. The primary components of a DWSRF balance sheet are:

- *Assets:* cash and cash equivalents, debt service reserves (if debt has been issued), loans outstanding, and federal grants receivable. (Only the portion of grants s“earned” but not yet received should be reported on the balance sheet.)
- *Liabilities:* state match bonds outstanding and leverage bonds outstanding.
- *Net Assets:* federal contributions, state contributions, and retained earnings or fund balance.

Financial resources (assets) minus obligations (liabilities) equal net assets.

The **Statement of Revenues, Expenditures, and Changes in Net Assets** is the second financial statement typically found in an audit report for DWSRFs. This statement presents the revenue and expenses incurred *over the course of the audited period*, usually broken down to highlight revenue and expenditures specific to categories such as the DWSRF and the debt service/loan fee.

This statement shows revenues for the current period, such as interest on loans and investments, minus expenses such as interest expense, bond issuance costs, and administrative expenses. Capitalization grants are now typically shown as “other” or “nonoperating” revenues, with the possible exception of the portion of the grant used to reimburse administrative and set-aside costs, which may be reported under “operating revenues.” The annual excess or deficit of revenues over expenses is included in the net assets (retained earning/fund balance) reported on the balance sheet and affects the total equity or capital available to the program.

The **Statement of Cash Flows** is the third financial statement that is included in an audit report. It shows the additions and subtractions from cash for the current period. The statement should report the cash effects during the period of the SRF’s operations, noncapital financing transactions, capital and related financing transactions, and investing transactions. A reconciliation of operating income with net cash flow from operating activities also should be provided. (Major cash inflows include such items as loan principal repayment, bond proceeds, and withdrawals from debt services. Among the major cash outflows are such items as loan disbursements, bond principal repayments, bond interest payments, and deposits to debt service reserves.) The net result is the change in cash for the current period. This amount is added to the beginning cash or cash balance of the prior year to get to the cash balance on the balance sheet.

Since DWSRFs operate for the purpose of providing loans, operating activities are similar to investing activities in most other entities. DWSRF cash flow statements, therefore, will list mainly operating and financing cash flows. Operating cash flows include interest receipts, loan receipts, federal and state reimbursements for SRF administrative and set-aside expenditures, payments for program administration, technical assistance, and management, and disbursements on loans (GASB 9). Financing cash flows may include funds received from state and federal governments to capitalize the loan fund, proceeds and repayments of debt, and payments under capital lease obligations.

### *Notes to the Financial Statements*

Directly following the financial statements is a section of **notes to the financials**. These notes provide more information on the background of the audited organization. They can include descriptions of accounting principles, restrictions on loans for payback or payout, and the post responsible for maintaining records and keeping track of incoming and outgoing cash equivalents. The notes present information that is necessary to interpret the financial statements but cannot be expressed in the statements themselves. The notes also explain the details of significant accounts. For example, they discuss where cash is invested and the risks involved (although most SRF funds are deposited with state treasurers so there usually is little risk). Notes also can provide details on the amounts in various accounts represented by the financial statements.

These notes are required by GAAP for full disclosure of the financials. In the case of an SRF program audit, these notes often contain information about the meeting of program requirements, such as fund matching requirements, and current contributions from the state and federal grants.

### *Internal Control and Compliance Reports*

Many audit reports include reports on the internal control structure and compliance with regulations. For SRF programs, internal control and compliance reports are nearly as important as the financial audit report. "The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use . . . and that transactions are executed in accordance with management's authorization and recorded properly . . . in accordance with generally accepted accounting principles" (Dayton 2003).

GAGAS contain requirements for auditor reporting on internal control, but they do not require the auditor to render an opinion on internal control (U.S. General Accounting Office 2003, 2). Instead, auditors state in **internal control reports** whether they have seen any material weakness in the internal control structure during their field tests of the financial statements.

The South Carolina DWSRF Program audit internal control report provides typical language when no material weaknesses are found:

In planning and performing our audit of the financial statements of the Program for the year ended June 30, 2002, we obtained an understanding of the internal control structure. With respect to the internal control structure, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control structure.

Accordingly, we do not express such an opinion.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses under standards issued by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of one or more of the specific internal control elements does not reduce to a relatively low level the risk that errors and irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control structure and its operations that we consider to be material weaknesses as defined above (Dayton 2003a, 11).

**Reports on compliance** are also very important components of an audit, especially for programs whose activities are bound by regulations and laws. Compliance testing is generally completed as a part of obtaining reasonable assurance on whether the SRF's financial statements are free of material misstatement. The auditor tests compliance with certain provisions of laws, regulations, contracts, and grant agreements that could have a direct and material effect on the determination of financial statement amounts. An audit conducted in accordance with GAGAS does not require an auditor to express an opinion on compliance in general. If sufficient audit work is performed, however, an auditor may provide an opinion.

The AICPA Audit Guide, *Government Auditing Standards and Circular A-133 Audits*, recommends that compliance reporting be combined with internal control reporting in one report. The compliance portion of the report should include:

- A statement regarding the scope of compliance testing completed.
- A statement that providing an opinion on compliance with applicable provisions was not an objective of the audit and an opinion is not expressed. If sufficient work was completed to provide an opinion, a statement describing the scope of work completed and the appropriate opinion should be included.
- A statement that notes whether the results of tests disclosed any instance of noncompliance or other matters that are required to be reported under GAGAS and, if they are, describes the instances of noncompliance or refers to a schedule in which the noncompliance, responsible officials, and their planned corrective action are included.
- If applicable, a statement that additional matters were communicated to the auditee in a management letter.

- A statement that the report is intended solely for the information and use of the audit committee (if applicable), management, and specific legislative or regulatory bodies (including EPA) and is not intended to be and should not be used by anyone other than these specified parties.

Compliance audits ensure that programs are complying with regulations and are using their funding in a manner consistent with the purpose of the program.

As with financial audit reports, compliance reports may contain unqualified or qualified opinions. An example of a qualified opinion comes from the report on the FY2002 audit of New Hampshire's DWSRF:

In our opinion, except for matters discussed in the Findings and Recommendations Section, the Program complied, in all material respects, with the specific program requirements that are applicable to the Program for the year ended June 30, 2002 (Dayton 2003, 14).

### *Findings and Recommendations*

A report on compliance is often followed by a section on **Findings and Recommendations**. Here the auditors raise issues that they feel need to be addressed by the audited entity's management or that do not follow the applicable federal and state laws, regulations, or policy requirements of the program. An auditor can find that a program is in compliance, except as noted in the Findings and Recommendations section.

At the end of the audit process, the findings and recommendations written by the auditors are given back to the audited entity for its response, which includes proposals for changes that need to be made or a defense of its actions. The auditor and the audited entity will communicate about the audited entity's response to each recommendation. Those responses are included in the Findings and Recommendations section of the audit report issued. Upon receipt of an audit report for a DWSRF program, it is EPA's responsibility to work with the state on issues identified in the report.

Audits are not considered closed until the audited entity responds to every finding or recommendation and can prove that it has implemented its response if it necessitates a change within the organization.

The matters referred to in the New Hampshire compliance report cited above are provided below as an example of a Findings and Recommendations Section (Dayton 2003, 15).

## Findings and Recommendations

### State Match

As of June 30, 2002, the Department of Environmental Services (DES) had received \$111,345 in excess federal funds and had a \$111,345 shortfall in State Funds required to be in the revolving loan fund. Per 40 CFR 35.3550(g), the state is to deposit 20 percent of each capitalization grant into the revolving loan fund. EPA's "Guide to Using EPA's Automated Clearing House for the Drinking Water State Revolving Fund Program" provided further details on how the state match should be provided. Per that guidance, the ratio of the state match to total federal and state funds is calculated as follows:

State match ratio = state match/(capitalization grant – set-asides + state match)

Using this formula, the State should have deposited \$626,496 of state match funds and drawn \$2,599,960 in federal funds for project costs totaling \$3,226,456 being funded from the 1999 capitalization grant. The state had actually deposited \$515,151 in State match and drawn \$2,711,306 in Federal funds.

### State Response

Since June 30, 2002, the state used additional state match funds on projects until the proper ratio of state match to Federal funds was achieved. The formula used to make draws has also been adjusted so that the proper ratio will be maintained in the future. The State wants to make it clear that the ratio that was formerly being used was the same formula mentioned in the above mentioned finding, the EPA document "Guide to Using EPA's Automated Clearing House for the Drinking Water State Revolving Fund Program" issued in September 1998. The misunderstanding is the interpretation of the way in which the formula was written. The State interpreted the formula to be based on federal dollars when in fact it was meant by EPA to be based on using total dollars.

### Cost Allocation

The Water Supply Engineering Bureau's Administrator's salary and benefits were charged to the DWSRF's administration set-aside during the year, even though the Administrator oversees multiple drinking water programs and activities, such as enforcement, monitoring, operator certification, public water supply supervision, source water protection, and water management. The DWSRF administration set-aside is only to be used for administration of the DWSRF or technical assistance to public water systems. According to 40 CFR, Part 31 and OMB Circular A-87, the distribution of salaries of employees who work on multiple activities should be supported by personnel activity reports documenting the time spent working directly on the program or may be allocated indirectly based upon a cost allocation methodology that is



developed, documented, and maintained for audit. Assuming that the Administrator devotes 20 percent of his time working on DWSRF activities, approximately 4/5 of the costs charged to the DWSRF Administration set-aside, or approximately \$54,000 is questioned as ineligible.

### **State Response**

The Administrator's salary and benefits have been changed and are now being charged to the State Program Management Set-aside, and no more than 20% of his time will be allocated to the DWSRF Administration Set-Aside. It is important to note that the Intended Use Plan submitted to EPA Region I was approved with the Administrator's salary being charged to administration.

### *Supplements*

In some audit reports, **supplemental information** is provided at the end of the report, usually to meet a program's audit regulations or to better inform readers of the audit report. In the case of SRF audits, the supplemental material often includes extra information regarding set-asides and loan activities. The New Hampshire DWSRF audit, for example, provided as supplemental information a "Schedule of Set-aside Expenses" and a "Schedule of Loan Activity and Binding Commitments."

**Appendix A**  
**Sample Audit Engagement Letter**

U.S. Environmental Protection Agency  
Washington, DC 20460

Office of Inspector General

[Date]

M(s)(r). XXXXXXXX, Manager  
XXXX State Revolving Fund  
Department of Environmental Quality  
Example City, ST 00000

Dear M(s)(r). XXXXXXX:

This letter confirms our understanding of the services we will provide to the XXXXX State Revolving Fund program for the year ending June 30, 200X.

We will audit the XXXX State Revolving Fund program (Program) financial statements as of and for the year ending June 30, 200X. The objective of the audit is to express opinions as to whether the presentation of the Program financial statements conforms with accounting principles generally accepted in the United States of America. In conducting the audit, we will perform tests of the accounting records and such other procedures as we consider necessary in the circumstances to provide a reasonable basis for our opinions on the Program financial statements. We also will assess the accounting principles used and significant estimates made by management, as well as evaluate the overall presentation of the Program financial statements.

The Program's management is responsible for the Program financial statements and all accompanying information as well as all representations contained therein. Encompassed in that responsibility is the establishment and maintenance of effective internal control over financial reporting; the establishment and maintenance of proper accounting records; the selection of appropriate accounting principles; the safeguarding of assets; the prevention and detection of fraud; and compliance with relevant laws, regulations, grants, and contracts.

Our responsibility is to:

- express an opinion on the fairness of the XXX Water State Revolving Fund Program financial statements prepared by the State of XXX, 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 XWSRF. The report will describe 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 that includes an opinion as to whether the state has complied, in all

material respects, with laws, regulations, and provisions of the XWSRF capitalization grants.

If circumstances preclude us from issuing unqualified opinions, we will discuss the reasons with you in advance. If, for any reason, we are unable to complete the audit or have not formed an opinion on the Program, we may decline to express an opinion as a result of the engagement.

We will conduct the audit in accordance with auditing standards generally accepted in the United States of America and Government Auditing Standards issued by the Comptroller General of the United States. Those standards require that we obtain reasonable rather than absolute assurance about whether the Program financial statements are free of material misstatement, whether caused by error, abuse or fraud. Accordingly, a material misstatement may remain undetected. In addition, an audit is not designed to detect error or fraud that is immaterial to the Program financial statements. Because the determination of abuse is subjective, Government Auditing Standards does not expect auditors to provide reasonable assurance of detecting abuse. We will inform you of illegal acts that come to our attention, unless they are clearly inconsequential, as well as all matters of fraud that come to our attention. We also will communicate certain other matters of interest to you, including changes in significant accounting policies or their application and adjustments arising from the audit that could either individually or in the aggregate have a significant effect on the Program's financial reporting process.

In planning and performing our audit, we will consider the Program's internal control to determine the nature, timing, and extent of our audit procedures for the purpose of expressing an opinion on the Program's financial statements, and not to provide assurance on internal control. An audit is not designed to provide assurance on internal control or to identify probable reportable conditions. However, we will make you aware of any reportable conditions that come to our attention.

In planning and performing our audit, we will ask management, the audit committee, the internal auditor, and others within the entity about fraud or suspected fraud; allegations of fraud or suspected fraud; the risks of fraud; programs and controls established to prevent and detect fraud; whether management has communicated information about those programs and controls to the audit committee; and how management communicates to employees its views on business practices and ethical behavior.

As part of obtaining reasonable assurance about whether the Program's financial statements are free of material misstatement, we will perform tests of the Program's compliance with certain provisions of laws, regulations, grants, and contracts. However, it is not our objective to provide an opinion on overall compliance with such provisions.

The Programs' management agrees to make available to us all records, documentation, and information we request in connection with our audit, to disclose to us all material information,

and to give to us the full cooperation of the Program's personnel. As required by auditing standards generally accepted in the United States of America, we will make specific inquiries of management about the representations embodied in the Program's financial statements and the effectiveness of internal control. We also will obtain a representation letter from management about those matters. The responses to our inquiries, the written representations, and the results of audit tests comprise the evidential matter we will rely upon to form our opinion on the Program financial statements.

The Program's management is responsible for adjusting the Program financial statements to correct material misstatements and for affirming to us in the representation letter that the effects of any unrecorded misstatements aggregated by us during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the Program financial statements.

Accounting standards generally accepted in the United States of America provide for certain required supplementary information (RSI), such as a management's discussion and analysis (MD&A), to accompany the Program's financial statements. As part of our engagement, we will apply certain limited procedures to the Program's RSI. Those limited procedures will consist principally of inquiries of management regarding the methods of measurement and presentation, which management will affirm to us in its representation letter. Unless we encounter problems with the presentation of the RSI or with our procedures relating to it, we will disclaim an opinion on the RSI.

Supplementary information other than RSI, such as statistical data, may also accompany the Program's financial statements. We will subject all supplementary information that is financially oriented to the audit procedures applied in our audit of the basic financial statements and render our opinion on whether that information is fairly presented, in all material respects, in relation to the Program financial statements taken as a whole. We will disclaim an opinion on supplementary information that comprises non-accounting information or accounting information not directly related to the Program financial statements. We also will make specific inquiries of management about supplementary information, which management will affirm to us in its representation letter.

A separate attachment describes the assistance that Program personnel will provide to us, including the preparation of schedules and analyses of accounts. Timely completion of that work will facilitate the completion of our audit.

You agree to provide us your basic financial statements and accompanying information for our review and approval before printing. You also agree to provide us with a copy of the final reproduced material for our approval before distributing it.

Our target date for delivering our auditor's report assume we will receive the aforementioned

assistance from your personnel and that we will not encounter unexpected circumstances. We will notify you immediately of any circumstances we encounter that could significantly affect our initial estimate of our report delivery date, which is on or about [date]. Such circumstances might include, for example, the identification of unexpected findings.

The audit documentation for this engagement is the property of the Office of Inspector General and constitutes confidential information. However, we may be asked to make certain audit documentation available to regulatory agencies based on authority given to them by law or regulation. If requested, we will provide supervised access to that audit documentation. Furthermore, upon request, we may provide photocopies of selected audit documentation to regulatory agencies. Those regulatory agencies may intend, or decide, to distribute the photocopies or information contained therein to others, including other governmental agencies.

If this letter correctly expresses your understanding, please sign the enclosed copy and return it to us.

We appreciate the opportunity to serve you and look forward to answering any questions you have about this letter or our services.

Sincerely,

Office of Inspector General

[Assignment Manager's Signature]

Accepted and agreed to:

[Client Representative's Signature]

[Title]

[Date]

enclosure: Required assistance from Program personnel

### Required Assistance from Program Personnel

Prior to beginning fieldwork, we ask that you provide the following information for our audit:

- XXXX CWSRF and DWSRF (jointly referred to as “SRF”) financial statements and trial balances for the year ended June 30, 200X;
- Detail general ledgers including beginning balances, transactions made during the year, and ending balances for all SRF accounts, including set-asides and administration fees for the year ended June 30, 200X;
- Schedule of cash balances as of June 30, 200X that details all cash and investment balances in the SRF and those SRF-related cash balances held outside the SRF (i.e., administration fees, set-asides, etc.) along with contacts to be used in the preparation of confirmations;
- Detailed listing of loans outstanding during the year ended June 30, 200X, including original loan amount, binding commitment date, balances at June 30, 200a and June 30, 200X, loan advances made during the year ended June 30, 200X, repayments received during the year ended June 30, 200X, interest/fee receivable at June 30, 200a and June 30, 200X, interest/fee income earned during the year, interest/fee payments received during the year; totals from this schedule should agree with the appropriate trial balance and general ledger account balances;
- Loan amortization schedules for all loans entered into since inception of the program;
- List of Borrowers, contact, address and phone number to be used to prepare loan confirmations;
- Schedule of grant awards and payments received and state match deposited since inception of the program;
- Detail listing of Accounts Payable as of June 30, 200X;
- The two most recent annual/biennial reports;
- SRF Program manuals, administrative procedures, accounting manuals, organization charts for programs, flowcharts, and other operational documentation, as available;
- Copy of most recent Single Audit covering either CWSRF and/or DWSRF;
- List of key program contacts within the SRF programs and of all State entities associated with the programs, i.e., accountant(s), auditor(s), attorney(ies), Treasurer’s Office.

We will need your assistance in preparing several confirmation letters that we can use to confirm loan balances, cash in the state treasury, and any pending legal issues. At the conclusion of our audit, we will also request certain written representations from you about financial and related matters.

**Appendix B**  
**Sample Management Representation Letter**



## Management Representation Letter

State Revolving Fund  
Department of Environmental Quality

[Date]

Mr. Paul Felz, SRF Project Manager  
U.S. Office of Inspector General  
999 18th St., Suite 300  
Denver, CO 80202

Dear Mr. Felz:

We are providing this letter in connection with your audit of the XXXX State Revolving Fund program's (SRF) financial statements as of June 30, 200X, and for the year then ended. The purpose of your audit is to express opinions as to whether such financial statements present fairly, in all material respects, the respective financial position of the SRF program and the respective changes in financial position and the cash flows in conformity with accounting principles generally accepted in the United States of America. The XXXX SRF program's financial statements include all program activities related to the SRF in accordance with 40 CFR Part 35. We confirm that we are responsible for the fair presentation of the SRF program's financial statements in conformity with accounting principles generally accepted in the United States of America and for establishing and maintaining effective internal control over financial reporting. We also confirm that we are responsible for the SRF program's compliance with laws, regulations, and provisions of grants and contracts.

Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information relating to an opinion unit that, in light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on that information would be changed or influenced by the omission or misstatement.

We confirm, to the best of our knowledge and belief, as of February 4, 2005, the following representations made to you during your audit:

1. We have made available to you all:
  - a. Financial records and related data
  - b. Minutes of the Water Quality Board, or summaries of actions of recent meetings for which minutes have not yet been prepared
  - c. Audit and relevant monitoring reports received from funding sources and regulatory agencies, none of which indicate noncompliance or deficiencies that

- require financial statement adjustment or note disclosure
2. All material transactions have been properly recorded in the accounting records or financial statement preparation worksheets underlying the financial statements.
  3. The financial statements of each program unit, including the notes thereto, referred to above are fairly presented in conformity with accounting principles generally accepted in the United States of America, including, as follows:
    - a. The financial statements include all program units as well as joint ventures with a financial interest, and properly disclose all other joint ventures and other related organizations. In addition, all program units have been properly displayed as discrete or blended.
    - b. The financial statements properly classify all activities.
    - c. Net asset components (invested in capital assets, net of related debt; restricted; and unrestricted) and fund balance reserves and designations are properly classified and, if applicable, approved.
    - d. Provisions for uncollectible receivables, if any, have been properly identified and recorded.
    - e. Expenses are appropriately classified in the activity statements, and allocations of expenses among functions and programs have been made on a reasonable basis.
    - f. Revenues are appropriately classified in the activity statements, including as program revenues or contributions to permanent fund principal on the statement of activities.
    - g. Interfund, internal, and intra-entity activity and balances are appropriately classified and reported.
    - h. Special and extraordinary items are appropriately classified and reported.
    - i. Deposit and investment risks relating to credit risk, concentration of credit risk, interest rate risk, and foreign currency risk have been identified and disclosed.
    - j. Capital assets, including infrastructure assets, are properly capitalized, reported, and, if applicable, depreciated.
    - k. The SRF program meets the GASB-established requirements for using the modified approach to account for eligible infrastructure assets.
  4. We have considered the financial statement misstatements you aggregated during your audit, and have corrected our financial statements and accounting records for misstatements that are material to the applicable program unit. We believe that the effects of the uncorrected financial statement misstatements, which are in the listing attached to this letter, are immaterial, both individually and in the aggregate, to the applicable program unit.
  5. We acknowledge our responsibility for the design and implementation of programs and controls to prevent and detect fraud.
  6. We have no knowledge of fraud or suspected fraud affecting the entity involving:
    - a. Management
    - b. Employees who have significant roles in internal control
    - c. Others where the fraud could have a material effect on the financial statements

7. We have no knowledge of any allegations of fraud or suspected fraud affecting the entity received in communications from employees, former employees, analysts, regulators, or others.
8. We have identified and disclosed to you all compliance requirements that could have a direct and material effect in the determination of financial statement amounts. There are no known or possible violations of legal or contractual provisions whose effect should be considered for disclosure in the financial statements or as a basis for recording a loss contingency or other financial statement adjustment. In particular, the SRF program has complied with such provisions concerning:
  - a. Reporting specific activities in separate funds
  - b. Adopting, approving, and amending budgets
  - c. Debt limits and covenants and secondary market disclosures
  - d. Deposits and investments, including collateral requirements on depository accounts and investments
  - e. Fees and refunds
  - f. Internal Revenue Service (IRS) employment taxes and arbitrage
9. There are no:
  - a. Unasserted claims or assessments that our lawyer has advised us are probable of assertion and should be disclosed in accordance with accounting principles generally accepted in the United States of America, including Financial Accounting Standards Board (FASB) Statement No. 5, Accounting for Contingencies
  - b. Other liabilities or gain or loss contingencies that are required to be accrued or disclosed by accounting principles generally accepted in the United States of America, including FASB Statement No. 5
10. The SRF program has no plans or intentions that may materially affect the carrying value or classification of assets, liabilities, or net asset components.
11. The following have been properly recorded or disclosed in the financial statements:
  - a. Related-party transactions, including fees, interest, loans, transfers, leasing arrangements and guarantees, and amounts receivable from and payable to related parties
  - b. Guarantees, whether written or oral, under which the SRF program is contingently liable
12. We have identified to you all significant estimates that affect the financial statements, including the key factors and significant assumptions underlying those estimates, and believe the estimates are reasonable in the circumstances.
13. The SRF has satisfactory title to all assets, and, except for the arrangements with financial institutions concerning reverse repurchase agreements and compensating balances, which are disclosed in the financial statements, there are no liens or encumbrances on assets nor has any asset been pledged as collateral.
14. No events have occurred subsequent to the financial statement date and through the date of this letter that would require adjustment to, or disclosure in, the financial statements.

15. The SRF program is subject to an audit in accordance with Government Auditing Standards or the Single Audit Act Amendments of 1996 and Office of Management and Budget [OMB] Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations.
16. Required Supplementary Information is measured and presented within prescribed guidelines.
17. The combining and individual fund financial statements have been prepared and presented in conformity with accounting principles generally accepted in the United States of America and are consistent with the accounting principles used to prepare the basic financial statements.

[Program Manager's Signature]

[Finance Director's Signature]

enclosure: Uncorrected financial statement misstatements

**Appendix C**  
**Single Audits**

## Single Audits

Nonfederal organizations that expend \$500,000 or more a year in federal grants, loans, or prime contracts are subject to the Single Audit Act. Among these organizations are state and local governments, Indian tribes, and nonprofit entities. Also included are recipients of DWSRF loans in excess of \$500,000 a year. Audits of these entities are performed to make sure no improper payments are made: in other words, to make sure that the projects funded by DWSRF loans meet the eligibility requirements of that program.

Most nonfederal entities prepare annual financial statements and have them audited. A single audit combines the annual financial statement audit with additional audit coverage of federal funds. Single audits are intended to meet the basic audit needs of the nonfederal agencies and the federal agencies that award them funds (U.S. Chief Financial Officers Council 2001a). However, single audits are not intended to provide detailed audit coverage of all the federal awards made to the auditee or to provide detailed information about individual awards (U.S. Chief Financial Officers Council 2001).

A single audit is a rigorous, organization-wide review that has financial and compliance components. Single audits are the government's way of making sure that recipients of major federal grants and other forms of financial support are using the money properly and are adhering to a uniform set of accounting standards at an entity-wide level (Flood 2002).

Single audits are also known as A-133 audits, in reference to OMB Circular A-133. That circular, and its companion compliance supplement, specify the procedures to be followed in conducting a single audit. Circular A-133 gives the auditor additional testing and reporting responsibilities for compliance and for internal control over compliance beyond the financial statement audit performed in accordance with GAAS. For more information on single audits and OMB Circular A-133, go to the Federal Audit Clearing House home page at <http://harvester.census.gov/sac>.

A single audit's two main objectives are:

- An audit of the entity's financial statements and the reporting on the Schedule of Expenditures of Federal Awards (SEFA) in relation to those financial statements.
- A compliance audit of federal awards expended during the fiscal year. This compliance audit provides a basis for issuing an additional report on compliance related to major programs and on internal control over compliance (AICPA 2004a).

A single audit covers an organization's financial books of account, general management, and systems of internal control. It also includes a review of the federal assistance received by the organization during the audited period. The financial review examines the books of account,

financial statements, and general award transactions to determine whether they fairly and accurately describe the results of the auditee's operations in accordance with GAAP (Flood 2002).

The compliance review is a component of a single audit. The auditor is required to determine whether the entity complied with laws, regulations, and provisions of contracts or grant agreements pertaining to federal awards that have a direct and material effect on each major program. The auditor is required to express an opinion on whether the entity complied with laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on each major program. Where applicable, the auditor also is required to refer to a separate schedule of findings and questioned costs.

In addition to meeting the requirements of *Government Auditing Standards*, the auditor is required to:

- Perform procedures to obtain an understanding of internal control over federal programs that is sufficient to plan the audit to support a low assessed level of control risk for major programs.
- Plan the testing of internal control over major programs to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program.
- Perform tests of internal control, unless the internal control is likely to be ineffective in preventing or detecting noncompliance.

A written report on internal control over major programs is required in describing the scope of testing of internal control and the results of the tests and, where applicable, referring to a separate schedule of findings and questioned costs (AICPA 2004a).

#### *Single Audits and Independent Audits of SRF Programs*

Rarely do single audits provide enough financial detail on SRF programs to qualify as program-specific audits. There are exceptions, however. In recent years, only Texas' statewide single audit has been detailed enough financially to evaluate the program's financial condition, results of operations, and ability to meet the perpetuity requirements of the SDWA.

Although they tend not to provide financial details on state DWSRF programs, single audits can provide good information or assurances on the audited state's internal controls and compliance. Thus, single audits can be supplemented by independent audits of the SRF program conducted by the OIG, the state audit agency, or outside auditors hired by the state. OMB Circular A-133 notes that any additional audits beyond the single audit must be planned and performed in a way

that builds on the work performed by other auditors. Failure to consider the work of the auditors who conducted the single audit when conducting an independent audit of an SRF program can waste the auditors' and the state's time.

### *Single Audit Deficiencies*

According to the AICPA's Government Audit Quality Center Web site, the AICPA peer review and disciplinary processes continue to indicate problems with the single audits they review. Federal OIGs also have found similar problems in their quality control reviews of single audit work. Some of the most common deficiencies are the result of errors made by auditors in applying the risk-based approach required by Circular A-133 for determining major programs. The following list provides a summary of the deficiencies identified. Details are available at <http://gapc.aicpa.org/Resources/OMB+Circular+A-133+Audits/Common+Engagement+Deficiencies>.

- **Failure to audit as major programs type A programs that do not qualify as low risk** because the auditor misapplied the criteria for determining whether a program should be considered low risk.
- **Failure to audit type A programs as major because of errors made in determining the type A/type B program dollar threshold**, including mathematical errors in determining the threshold and erroneously basing calculations on interim, rather than final, federal awards expended amounts.
- **Failure to audit all programs included in a cluster of programs**, which should be considered as one program in determining major programs, and errors in identifying programs as part of a program cluster.
- **Failure to meet the percentage-of-coverage requirement in Circular A-133, section 520(f)**, which is the last step in the risk-based approach and must always be met.
- **Inadequate or outdated reference material** used in the audit engagement.
- **Various documentation problems**, including internal control and compliance tests that were not always adequately documented to support the reports issued.
- **Problems with the GAAS audit of financial statements**, including failure to follow GAAP requirements.
- **Engagement letter deficiencies**, including failure to include proper references to Circular A-133 requirements or record retention policies and failure to include a copy of the latest peer review report.



- **Inadequate *Government Auditing Standards* reporting**, including failure to prepare the required reports for internal control or compliance.
- **Inadequate Circular A-133 reporting**, including failure to include appropriate Circular A-133 reporting or to use the appropriate report wording.
- **Inappropriate compliance opinion**, including the provision of an unqualified opinion even when there were material instances of noncompliance.
- **Problems with compliance and internal control work**, such as failure to perform required compliance testing because the auditor did not follow appropriate guidance to identify compliance requirements to test and report on.
- **Audit findings and supporting documentation lacking** so there is insufficient detail for the auditee to prepare a corrective action plan and for federal agencies and pass-through entities to arrive at a management decision.
- **Issues with the SEFA**, including failure to present or report on the SEFA and presenting a schedule that did not accurately reflect the federal expenditures of the auditee (AICPA 2004).

