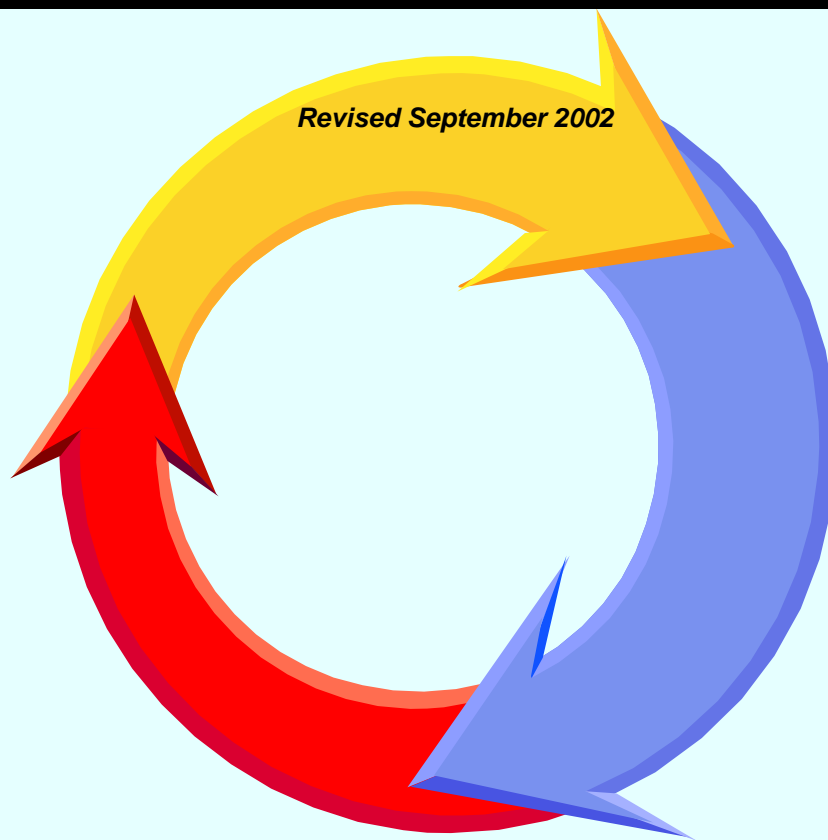


***Environmental Protection Agency
Audit Guide for
Clean Water and Drinking Water
State Revolving Fund Programs***



Abbreviations

The following abbreviations are often used in this guide:

ACH	Automated Clearing House
AICPA	American Institute of Certified Public Accountants
CFDA	Catalog of Federal Domestic Assistance
CFR	Code of Federal Regulations
Clean Water Act	Title VI of the Clean Water Act of 1987
Drinking Water Act	Safe Drinking Water Act Amendments of 1996
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
OMB	Office of Management and Budgets
SAS	AICPA Statement of Auditing Standards
SRF	State Revolving Funds

PREFACE

This audit guide was originally issued in June 1998 as an aid to performing financial audits of the Clean Water State Revolving Funds (hereafter referred to as SRFs) administered by states. This guide is intended to be used by all auditors who perform Clean Water and Drinking Water SRF financial statement audits.

Several factors prompted the need to revise the guide. First, the Safe Drinking Water Act Amendments (referred to as the Drinking Water Act) of 1996 established the Drinking Water State Revolving Loan Program. The Drinking Water program is very similar to the Clean Water program except the “set-asides” and certain other operational aspects. The accounting for the loan portion of the two programs is the same. Many states operate both programs in the same organization or department, and including both programs in a single document seemed logical. The Drinking Water Act allows states to administer their Drinking Water SRF in combination with other state loan programs, including the Clean Water SRF. It also allows a state to transfer up to 33 percent of a particular fiscal year’s Drinking Water capitalization grant between the Clean Water and the Drinking Water programs at the state’s discretion, and assets of both programs can jointly guarantee or secure debt issued. These provisions linking the Clean Water and Drinking Water SRF programs signal Congressional intent to implement and manage the two programs in a similar manner. When possible, the annual review of each program will be performed across both programs. This guide includes such revisions, as necessary. For these reasons, this guide combines auditing and reporting of both the Clean Water and Drinking Water programs.

Second, the Governmental Accounting Standards Board (GASB) has issued a number of pronouncements that affect financial reporting of the states, and the SRFs. These statements are:

- ! No. 33-Accounting and Financial Reporting for Nonexchange Transactions, issued December 1998,
- ! No. 34-Basic Financial Statements-and Management’s Discussion and Analysis-for State and Local Governments, issued June 1999,
- ! No. 37-Basic Financial Statements-and Management’s Discussion and Analysis-for State and Local Governments: Omnibus, issued November 2001, and
- ! No. 38-Certain Financial Statement Note Disclosures, issued November 2001.

GASB 33 and 34 have significant impacts on how state and local governments account for various activities and report those activities in the financial statements. GASB 33 was effective for years ending June 30, 2001, and GASB 34 will be phased in over a three-year period beginning for fiscal years beginning after June 15, 2001, depending on the size of the entity. Most SRF programs will be required to implement GASB 34 for years ending June 30, 2002. This guide is not intended to be used as an all-encompassing discussion on the implementation of GASB 34, but only identify how it may affect the SRFs based upon OIG experience. GASB 37 makes several relatively minor amendments to GASB 34 that may apply to some SRFs depending upon the individual circumstances. GASB 38 establishes disclosure criteria to add descriptions of activities accounted for in major funds, debt service disclosures, interfund transfers and other additional disclosures.

The Office of Management and Budget (OMB) has made some revisions to Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations, and the associated compliance supplement requires that suggested report formats be modified to conform to the revised guidelines.

Lastly, this revised audit guide includes additional sample financial statement formats that were not included in the original version. The new sample financial statements include suggested formats for

direct loan programs, leveraged programs, combined Clean Water SRF and Drinking Water SRF programs, and reporting of administrative funds and administrative fee income issues. In addition, different formats for the report on internal controls and compliance are included.

This guide is intended to identify accounting, financial reporting, and Federal compliance guidance that is applicable to the SRF programs. However, it is only a guide. Nothing is intended to replace the auditor's judgment and discretion. The guide cannot include all possible situations that may be encountered.

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CHAPTER 1

PURPOSE AND ORGANIZATION

INTRODUCTION

The State Revolving Funds operated by the states are unique to EPA. The SRFs are EPA's largest single program, accounting for about 50 percent of all assistance awards. There are 102 SRF programs nationally (all 50 states plus Puerto Rico, each operating a Clean Water and Drinking Water SRF). The size of the individual SRFs vary from small, direct loan programs with only a few loans, to large, leveraged programs that have several billion dollars in bonds and loans outstanding. There also are variations in how each state operates the SRF, and no two states are organized in the same manner.

A large number of states operate the Clean Water and Drinking Water programs in separate departments, the most common having the Clean Water SRF as a part of the state's environmental department, and the Drinking Water SRF operated by the health department. Some states have set up the SRFs in separate entities, ranging from quasi-public corporations to financing authorities to bond banks, while other states operate their programs as enterprise funds, special revenue funds, or part of the general fund. Some entities may have been established solely to operate the SRF (such as a quasi-public corporation), while in other states the SRF may be a part of other environmental or financial assistance operations.

There are also different levels of audit standards or requirements for SRF audits. As a minimum, SRF audits should be conducted according to Government Auditing Standards (often called the Yellow Book, generally accepted government auditing standards, or GAGAS), issued by the Comptroller General of the United States. Government Auditing Standards require, among other things, a report on the auditors consideration of internal controls and compliance with applicable federal requirements over financial reporting that is not required under American Institute of Certified Public Accountants (AICPA) Generally Accepted Auditing Standards (GAAS). Since Federal funds are involved, audits conducted solely under the AICPA Generally Accepted Auditing Standards do not meet the requirements of GAGAS. Several states audit the SRF under the Single Audit Act, which imposes additional compliance and reporting requirements. If auditors become aware that the entity being audited is subject to an audit requirement not encompassed in the terms of the engagement, the auditor should communicate to management that the audit being conducted may not meet the regulatory requirements.¹

PURPOSE

The purpose of this guide is to provide guidance in performing audits of the Clean Water and Drinking Water SRFs administered by states. This guide is for the use of EPA OIG auditors, state auditors and Independent Certified Public Accountants when performing SRF financial audits.

The guide is not intended to be a complete manual of procedures, nor is it an audit program. It is limited to matters that warrant special attention and/or that experience has indicated may be useful. This guide is also based on the assumption that its users are knowledgeable in accounting and auditing. As such, it focuses on specific areas of auditing, accounting and reporting relevant to the SRFs. It does not discuss the application of all accounting pronouncements or auditing standards that may pertain to SRF audits. The guide incorporates relevant auditing standards, including General Accounting Office (GAO)

¹

AICPA Statement on Auditing Standards (SAS) No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*.

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 guidance, EPA regulations, state laws, and/or pronouncements issued by the Financial Accounting Standards Board (known as FASB) and the Governmental Accounting Standards Board (known as 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 audits, and 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 not a duplication of audit effort. Accordingly, while relying on the work of others, the auditor should exercise judgment whether to perform additional work in each objective. In such cases, consultation with the OIG National SRF Audit Manager is encouraged.

ORGANIZATION OF THIS GUIDE

This guide is organized in the same manner that financial statement audits are conducted. Specifically, the Chapters are:

2. **Audit Objectives:** Discusses the objectives of audits of SRF programs, and focus of such audits.
3. **Background:** Provides statutory and regulatory authorities for the Clean Water and Drinking SRF programs. It also identifies how SRF funds can be used, how the states are funded, and identifies key documents that should be obtained as part of the permanent audit files.
4. **Planning the Audit:** Discusses determining the scope of audit, key documents, obtaining an understanding of the SRF, and defining the engagement with the state. Also discusses other factors, both internal and external, that may affect the audit and SRF operations.
5. **Management Assertions and Internal Controls:** Discusses how the financial statements are the representation of management, and how the statements are prepared according to assertions made by management, either explicit or implied. Assessing and testing the internal control structure provides reasonable assurance that transactions are properly recorded to validate the management assertions.
6. **Auditing the Financial Statements:** This chapter discusses determining whether the 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, and identifies the auditing and reporting concerns of SRFs.
7. **Compliance Auditing:** Provides guidance on compliance matters in SRFs that need to be addressed to determine whether the state has complied in all material respects with laws, regulations, and the provisions of SRF capitalization grants.
8. **Audit Completion and the Auditor's Reports:** Discusses completing the audit which involves obtaining a representation letter from the state, presenting the results of the audit, and the auditor's reports.

Appendices: The appendices include a listing of reference materials, sample engagement letters and representation letters, and sample financial statements intended to assist states and auditors in making the financial statements as informative as possible.

CHAPTER 2

AUDIT OBJECTIVES

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. Audited financial statements also provide EPA with assurances that the financial statements are fairly presented in accordance with GAAP, the internal control structure is adequate to safeguard the assets of the SRF, and that the states have complied with the important compliance provisions of Federal laws and regulations.

The objectives of audits of the SRFs administered by states 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;
- ∟ Report on the internal controls related to the financial statements of the SRF. 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
- ∟ Express an opinion as to whether the state has complied, in all material respects, with laws, regulations, and provisions of the SRF capitalization grants and other Federal laws, as applicable.

In order to achieve these objectives, the audit needs to be properly planned, conducted, and supervised. The **audit focus** is on a state's SRF programs, rather than individual capitalization grants awarded to the state. **The Clean Water SRF program should include all funds relevant to the program, including administrative or loan fee funds. The Drinking Water SRF program includes the loan fund, any set-asides utilized by a state, and administrative or loan fee funds.**

Audits are to be conducted in accordance with GAGAS, and include testing of accounting records and other procedures the auditor considers necessary to express an opinion that the financial statements of the State Revolving Fund are fairly presented, in all material respects. Audits 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 in the circumstances. The product of an audit generally includes issuing the following reports:

- ∟ 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. As a minimum, financial statements should include a statement of net assets or balance sheet, statement of revenues and expenses and changes in net assets, a statement of cash flows, and notes to the financial statements. Other statements may be required, depending upon the organization.
- ∟ A report on internal controls related to the SRF financial statements. The report should describe the scope of testing of internal control and the results of tests, and where applicable, refer to a separate schedule of findings and/or costs questioned.

c 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 objectives and the reports are discussed in more detail in the following chapters. The financial statements are the representation of SRF management, not the auditor. Auditors should be familiar with Governmental Auditing Standards issued by the Comptroller General of the United States, as well as Generally Accepted Auditing Standards issued by the AICPA. Recent events in the accounting profession will likely have affects on independence of auditors, scope of services, and increased responsibilities over a variety of areas.

CHAPTER 3 BACKGROUND

The Clean Water and Drinking Water SRFs are very similar in operation and design. There are some important procedural and compliance differences between the two programs, but accounting for the loan portion of both programs is the same.

When the Drinking Water State Revolving Program was established in 1996, it included some provisions that can affect the Clean Water SRF program. States can transfer up to 33 percent of a Drinking Water capitalization grant to the Clean Water program, or an equivalent amount to the Drinking Water program from the Clean Water fund. States may also combine Clean Water and Drinking Water fund assets to secure bond issues, which is known as “cross-collateralization.” Several states operate both programs in the same department or entity, and may have the same staff working on both Clean Water and Drinking Water SRFs. For those reasons, the two funds may be so intertwined as to make auditing one program without auditing the other at the same time very inefficient.

STATUTORY AND REGULATORY AUTHORITIES

CLEAN WATER SRF:

Title VI of the Clean Water Act of 1987 (referred to as the Clean Water Act) established the Clean Water SRF program (CFDA No. 66.458) to replace the wastewater treatment facilities construction grants program. The Clean Water SRF program is established in each state by capitalization grants awarded by EPA.

The expectation of the Clean Water SRF program is for each state to create a **permanent** revolving fund to provide funds for making **loans** to local governments to construct needed wastewater treatment facilities. The SRF can also be used for other types of projects such as:

- ∩ Implementing non-point 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 Clean Water 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 Clean Water SRF. When the Clean Water 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 Clean Water 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; and
- ☐ Pay the reasonable costs of administering the Clean Water SRF, provided that the amount does not exceed 4 percent of all grant awards.

The Drinking Water Act provides two additional “uses” for the Clean Water SRFs. States can transfer up to 33 percent of a Drinking Water capitalization grant to or from the Clean Water program. States may also “cross-collateralize” the two funds to better secure bond issues. Several conditions apply, and the proceeds of such bond issues for each fund must be allocated in the same proportion as the assets used to secure the bonds.

Uses of the Clean Water 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 Clean Water SRF can provide, and also discusses additional requirements, limitations, and procedures for establishing and operating the Clean Water SRF.

The Clean Water SRF program provides a high degree of flexibility for states in operating their revolving funds in accordance with each state’s unique needs and circumstances. EPA recognizes that each state may have different needs and has administered the SRFs to meet those particular needs.

DRINKING WATER SRF:

Title I of the Safe Drinking Water Amendments of 1996 (the Drinking Water Act) established the Drinking Water SRF program (CFDA No. 66.468) to provide assistance to states and communities to help the communities meet Federal drinking water requirements.

Like the Clean Water SRF, the Drinking Water SRF is established by capitalization grants awarded by EPA. Each state’s program is expected to be designed and operated to further the public health protection objectives of the Act, promote the efficient use of all funds allotted to the state, and to ensure the revolving loan fund is available in perpetuity for providing financial assistance to public water systems.

When the term Drinking Water SRF is used in this guide, it refers to the entire Drinking Water SRF program, including set-asides. The term “loan fund” is used when referring to the revolving loan fund. The term “set-aside fund(s)” is used to describe the various set-aside activities.

Loan Fund

The primary purpose of the Drinking Water SRF program is to create a permanent loan fund in each state for the states to make low-interest loans to public water systems to address current or prevent future violations of Federal drinking water standards. It can be used for public water system projects in the following categories:

- ☐ Water treatment
- ☐ Water transmission and distribution
- ☐ Source water protection
- ☐ Water storage
- ☐ Consolidation of water systems
- ☐ Creation of new systems (where such project will address existing public health problems caused by unsafe drinking water provided by existing sources.)

The loan fund can also be used to provide the following types of assistance:

- Refinance or purchase local debt obligations for projects initiated after July 1, 1993;
- Purchase insurance for or guarantee local debt obligations;
- Use revenues or otherwise provide security for debt obligations of the loan fund, provided the net proceeds of the sale of the debt obligations are deposited into the loan fund and used to provide assistance eligible under the Act.

Unlike the Clean Water SRF, the Drinking Water SRF can also be used to provide assistance to disadvantaged communities in the form of loan subsidies. Disadvantaged communities can have loan principal forgiven, may have negative interest rate loans, **and can extend the loan repayment period to 30 years after project completion (provided the loan does not exceed the expected useful life of the project)**. Also, the Drinking Water SRF can provide financing for privately owned water systems where the Clean Water SRF can only finance public systems.

Set-Aside Funds

The Drinking Water program also includes several “sub-programs,” called set-asides, that states can elect. A State may use a certain portion of its capitalization grants for the following activities:

- up to 4 percent of its allotment to administer the Drinking Water SRF and provide technical assistance to public water systems;
- up to 2 percent of its allotment to provide technical assistance to small public water systems;
- up to 10 percent of its allotment for state program management activities, including administration of the State Public Water System Supervision Program, administration of the source water protection program, development and implementation of the capacity development and operator certification programs;
- up to 15 percent of its capitalization grants to assist in the development and implementation of local drinking water protection initiatives and other State programs.

A significant difference between the Clean Water and Drinking Water SRFs is in the area of fund administration. The Clean Water SRF allows states to use up to 4 percent of the capitalization grant for administrative expenses in the Clean Water SRF. In the Drinking Water SRF, the 4 percent administrative set-aside and other set-asides **cannot be** part of the Drinking Water SRF fund. They must be deposited to separate funds, and must have separate accounting. For this reason, financial statements of Drinking Water SRFs must report all set-aside funds separate from the Drinking Water loan fund. Examples of how this separate reporting can be accomplished in the financial statements is included in the appendices.

Uses of the Drinking Water SRF are more fully discussed in the CFR, Part 40, Subpart L. The regulations identify the exact types of assistance that the Drinking Water SRF can provide, and additional requirements, limitations, and procedures for establishing and operating the Drinking Water SRF.

EPA implements the Drinking Water SRF in a manner that preserves a high degree of flexibility for states in operating their revolving funds and set-aside funds in accordance with each state’s unique needs and circumstances.

FUNDING THE STATE REVOLVING FUNDS

EPA’s capitalization grants provide the initial SRF financing. The Clean Water and Drinking Water 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.

When a state receives a capitalization grant, it agrees to a “payment schedule” with EPA. However, the “payment schedule” does not represent actual payments. A payment in SRF terms 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. A significant difference between the Clean Water and Drinking Water SRFs is in the area of required binding commitments. Amounts that states elect for the set-asides **do not affect the state match required, or the required binding commitments**. States must provide the 20 percent state match on the total Drinking Water capitalization grant, exclusive of all set-asides.

Draws are typically made when a state is presented with reimbursement requests from the loan recipients. Both Clean Water and Drinking Water programs require that draws from EPA be made in proportion to the total funds deposited to the SRF, also called proportionality. In a Clean Water direct loan program, the state will draw 83.33² percent of the requested amount from EPA, transfer the state share to the Clean Water 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. 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.

However, the EPA share for the Drinking Water program will only be 83.33 percent **if the state does not elect any set-asides, including the administrative set-aside**. States that only elect the administrative set-aside will have a state share of 17.24 percent. Proportionality can vary by year for the Drinking Water SRF, depending upon the set-asides elected by the state. The following table shows how the state portion of cash draws changes depending upon the set-asides³:

Year	Cap Grant	State Match	Set-aside	Federal	State	Total	Federal Portion	State Portion
1	100	20	15	85	20	105	81%	19%
2	100	20	20	80	20	100	80%	20%
3	100	20	31	69	20	89	78%	22%

States can also choose between specific grant proportionality, as shown above, or may use a rolling average. Funding the Drinking Water program and cash draws are discussed in detail in EPA’s “Guide to Using EPA’s Automated Clearing House for the Drinking Water State Revolving Fund Program.”

² For Clean Water SRF, the Federal and state shares are calculated as follows:

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

³ For the Drinking Water program, the formula to calculate Federal share is:

$$\frac{\text{Capitalization grant} - \text{set-asides}}{\text{Capitalization grant} - \text{set-asides} + \text{state match}}$$

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;
- Intended Use Plan;
- Annual/Biennial Report;
- Annual Review, and;
- 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 Operating Agreement. The Operating Agreement is incorporated by reference in the capitalization grant agreement. (40 CFR 35.3130(b), 40 CFR 35.3545(c)).

Intended Use Plan. 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 Intended Use Plan must be prepared annually and must be subjected to public comment and review before being submitted to EPA. (40 CFR 35.3150, 40 CFR 35.3555(a)). Workplans are required for set-aside activities of the Drinking Water SRF.

Annual Report. The State must provide an Annual Report to EPA (Biennial report for Drinking Water). The Annual Report includes information essential to EPA evaluating the SRF program, and includes how the state is meeting the goals and objectives of the program. (40 CFR 35.3165(a), 40 CFR 35.3570(a)). Financial statements are a required part of the Annual Report.

Annual Review. The Annual Review is EPA's assessment of the success of the State's performance of goals and activities identified in the Intended Use Plan and Annual Report, and to determine compliance with the terms of the capitalization grant agreement. (40 CFR 35.3165(c), 40 CFR 35.70(c)).

State's Single Audit Report. OMB Circular A-133 requires a state to conduct an annual audit, known as the Single Audit. The scope of this audit includes work that can be of value to the auditor conducting the SRF financial statement audit, especially in years in which the SRF is treated as a "major" program.

REFERENCE MATERIAL

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

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CHAPTER 4 PLANNING THE AUDIT

Conducting an audit of the financial statements of the SRF requires that the audit be properly planned and supervised. GAGAS for financial statement audits have incorporated the fieldwork standards established by the AICPA. The guidance in SAS No. 22, *Planning and Supervision*, provides procedures applicable to planning and supervising an audit.

Planning is an essential step in order 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 varies with the size and complexity of the SRF, the auditor's experience with the particular SRF, and the auditor's knowledge of the SRFs 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 recent 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 (or Biennial) 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 5 - Management Assertions and Internal Controls).

KEY DOCUMENTS AND INFORMATION

Preliminary planning for the audit engagement includes obtaining the key documents discussed in Chapter 3. 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, including the origin and history of the state's SRF, and the SRF's 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:

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

For Drinking Water programs, auditor's should also determine to what extent the state has elected to participate in the set-aside programs available.

SRF Management and Organization. As a starting point in gaining an understanding of the SRF, the state's legislation that established the SRF and implementing regulations 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 have a significant affect on 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 an 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 its 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. Some states account for the SRF as part of the general fund. While EPA has never issued any guidance on how to account for the SRF, GASB 34 does. While GASB 34 provides requirements for a governmental entity's basic financial statements, it also specifies the type of fund to be used for certain activities. These requirements will require a number of states to change the type used to account for the SRF. Chapter 6 - Auditing the Financial Statements, discusses the new accounting changes in detail.

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"⁴ its program, (3) current political climate, (4) relevant legislation, and (5) accounting pronouncements.

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) the number of other governmental agencies involved, (6) qualifications and competence

4

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.

of key personnel, and (7) turnover of key personnel. Participation in the set-asides of the Drinking Water program is also a key internal factor. Set-asides often include other state agencies and subcontractors, and understanding how the state operates the set-aside programs, and the extent of participation, will have material effects on the organization and audit.

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. Auditors should also be aware of recent accounting pronouncements, and how those pronouncements will affect the entity. GASB 33 and 34 require drastic changes in accounting for various items, and may have minimal effect on other items. Auditors should consider whether management has changed any accounting principles, and whether management appears to follow aggressive or conservative accounting policies. Understanding the state's SRF operations early 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: (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 B.

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CHAPTER 5 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:

- **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 valid 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 includes specific control objectives to address each assertion.

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 defined⁵ 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. The elements of the internal control system, and their relationship to the audit of the financial statements, are:

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:

- c Integrity and ethical values;
- c Commitment to competence;
- c Legislature or Governing board;
- c Management's philosophy and operating style;
- c Organizational structure;
- c Assignment of authority and responsibility, and;
- c 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 judgment.

⁵ AICPA Professional Standards, AU §319.06

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. The primary concern is to consider how the possibility that certain transactions not recorded could be prevented or detected.

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:

- o Changes in operating environment;
- o New personnel;
- o New or revised information systems;
- o Rapid growth or technology changes;
- o Reorganizations, or;
- o 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 that would be applicable to the SRF would include:

- o Performance reviews;
- o Information processing;
- o Physical controls, and;
- o 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 auditor's 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 affect on the potential for misstatement, and the design of substantive audit tests and procedures.

The information system includes methods and records that:

- c Identify and record all valid transactions;
- c Describe the transactions in enough detail to permit proper classification of transactions;
- c Measure the proper value of transactions;
- c Determine that the transactions are recorded in the proper time period;
- c Present the transactions and related disclosures in the financial statements, and;
- c Allow and promote 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 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 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:

- c Prior experience with the organization;
- c Inquiries of appropriate management, supervisory and staff personnel;

- c Inspection and testing of documents and records, and:
- c 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 judgment.

DOCUMENTING THE UNDERSTANDING

The understanding of Internal Controls should be properly documented in the workpapers. 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 aids. Regardless of the form and quantity, the documentation should include information on:

- c The classes of transactions that are important to the SRF;
- c How the transactions are initiated;
- c The source documents;
- c The accounting processing, including computer files;
- c The chart of accounts;
- c Samples of documents, journals, ledgers and reports generated by the financial reporting system;
- c Descriptions of control activities;
- c How the state provides the matching share of the SRF; and
- c 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 include details on the leveraging, including:

- c A description of the leveraging method used;
- c The type of bonds issued, such as general obligation, revenue, or other bonds;
- c How the SRF issues and accounts for bond proceeds, and the related liabilities, reserves, interest earned and paid, bond maturities, and other related matters;
- c Debt service requirements, and;
- c 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 that there could be 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 be directly or indirectly related 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 judgment, and can vary from year to year. For complex organizations and programs, flowcharts, questionnaires, and decision tables may be helpful in applying the tests and analyzing the results, and would also document 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:

- c Controls are unlikely to pertain to an assertion, or;
- c 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 type 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, provides 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 auditor 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:

- c 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?

- c 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?
- Have there been any 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 the 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 has changed that affect the controls being tested, then the interim work should not be relied upon for assessing the control risk.

CHAPTER 6

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 judgment must be used in conducting audits.

FINANCIAL REPORTING ENTITY AND SRF FINANCIAL STATEMENTS

With the audit objective focusing on the SRF financial statements, only the accounts of the SRF should be audited, with the opinion on the SRF financial statements. However, most SRF programs contain other accounts or funds that are an integral part of the SRF program, and are to be included as part of the basic financial statements. An example of such a fund would be an administrative or loan fee fund, as well as set-aside funds in the Drinking Water program. Many states charge a loan fee to borrowers to pay for future costs of administering the program. While the fee may be a one-time charge when the loan is originated, or an annual fee based on a percentage of the outstanding loan balance, the fund where the fee is deposited should be included with the basic financial statements of the SRF. Such fees are generally considered to be program income⁶, and EPA can direct the uses of such program income. Also, agency funds are sometimes used to account for the revenue bond activity of an SRF program, and in such cases, should be included as part of the financial statements as well.

In some states, 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. Many states operate the SRF program as part of a state-wide bond bank, or infrastructure authority. These organizations generally have audits because they have separate boards of directors, or are a quasi-public corporation. In such cases, auditing the SRF itself is a part of the overall audit of the organization. However, it is essential that the SRF operations be presented in the financial statements be included in the auditor's report, and may be included as supplemental information.

ACCOUNTING PRONOUNCEMENTS

There have been several statements issued by GASB since 1998 that have major impacts on the financial statements of government entities. Whether the SRF program is a part of the state's general government operations, or a special-purpose district, these statements dictate the format of the financial statements, and in many situations, the organization of the SRF program. These statements, and a brief discussion of how they affect the SRFs, is discussed in the following sections:

! No. 33-Accounting and Financial Reporting for Nonexchange Transactions, issued December 1998,

! No. 34-Basic Financial Statements-and Management's Discussion and Analysis-for State and Local Governments, issued June, 1999,

⁶ 40 CFR 31.25 defines program income as "gross income received by the grantee or subgrantee directly generated by a grant supported activity, or earned only as a result of the grant agreement during the grant agreement." In the case of loan fees, there would not be any fee generated if the state did not have the loan program.

! No. 37-Basic Financial Statements-and Management's Discussion and Analysis-for State and Local Governments: Omnibus, issued November 2001, and

! No. 38-Certain Financial Statement Note Disclosures, issued November 2001.

GASB 33: GASB 33 establishes the accounting and financial reporting standards for nonexchange transactions involving financial or **capital** resources, which includes most grants. A nonexchange transaction is when a government gives value to another party without receiving equal value in exchange. GASB 33 addresses the timing of when a nonexchange transaction occurs, and when the transaction should be recorded. GASB 33 identifies four classes of nonexchange transactions:

- (1) derived tax revenues, such as sales taxes and income taxes,
- (2) imposed nonexchange revenues, such as property taxes,
- (3) government mandated nonexchange transactions, such as mandated federal or state programs, and
- (4) voluntary nonexchange transactions, like certain grants and private donations.

Although none of the examples cited in GASB 33 are SRF specific, the government mandated transactions are most similar to the SRF. The SRF meets this requirement because the Federal government provides resources (capitalization grants) to the states, and requires that states use the resources for specified purposes. The principal characteristics of these transactions are (1) that the provider mandates that a recipient government perform a particular program, and (2) fulfillment of certain eligibility requirements is essential for a transaction to occur. In the SRF, EPA provides resources to the state on a reimbursement basis, and the recipient has incurred the costs. Until those eligibility requirements are met, there is no liability on behalf of EPA, and the state does not have a receivable. When all eligibility requirements are met, states should record the amount due as a receivable from EPA.

In practice, this means that the EPA capitalization grant should not be accrued when awarded. Only as reimbursement requests are received from the borrowers should the amount due from EPA be recorded. Similarly, loan commitments are not liabilities of the SRF until the communities make a reimbursement request. Additionally, footnote 18 requires recognition of capital contributions to proprietary funds and other entities that use proprietary fund accounting as revenues. These are non-operating revenues that should be shown after income from operating activities.

GASB 34: GASB 34 has substantial impacts on the fund type and the basis of accounting to be used for SRF operations. It also changes the format of the financial statements, and introduces Management's discussion and analysis (MD&A), a component of "required supplementary information" (RSI). MD&A should introduce the financial statements and provide an analytical overview of the financial activities. RSI is budgetary comparison schedules and other data as required by previous GASB pronouncements. While MD&A is part of RSI, it is presented before the financial statements.

Prior to GASB 34, there was little guidance on what type of funds to be used for governmental operations, and what was required in the basic financial statements. GASB 34 establishes financial reporting standards for state and local governments, including cities, special purpose districts, and public utilities. It requires the basic financial statements to include MD&A, government-wide financial statements, fund financial statements, notes to the financial statements, and required supplementary information. The term special-purpose districts would include separate legal entities, such as financing authorities, water boards, and other environmental agencies that contain SRF programs. If the entity

includes both governmental and business-type activities that many states have established⁷ the financial statements should be reported in the same manner as general purpose governments.

Special-purpose governments engaged only in business-type activities should present the financial statements for enterprise funds. The financial statements consist of MD&A, a statement of net assets (balance sheet), and a statement of revenues and expenses and changes in fund net assets, notes to the financial statements, and RSI, if applicable. The statements should report all assets, liabilities, revenues, expenses and gains and losses of the entity, and distinguish operations (such as Clean Water and Drinking Water) by presenting in separate rows and columns. Financial statements are to use the economic resources measurement focus and the accrual basis of accounting.⁸

GASB 34 also made significant changes to the financial statements as well. Assets and liabilities should be classified between current and long-term, and fund equity is now more properly known as “net assets.” Contributed capital is not to be shown as a separate component on the statement of net assets. Net assets should be shown in three components: invested in capital assets, restricted, and unrestricted. The most common designations for the SRF will be restricted, which are amounts to be used for debt service and interest payments and cannot be used for other purposes, and unrestricted.

The statement of revenues and expenses now includes changes in net assets, not just fund balance. Revenues should be reported by major source, and should identify revenues used as security for revenue bonds. It also distinguishes between operating and nonoperating revenues and expenses, and should report separate totals for operating revenues, operating expenses, and operating income. Nonoperating income should be shown after operating income. Capital contributions should be reported after nonoperating revenues and expenses as a separate line item. Operating income and expenses should be appropriate for the nature of the activity, and should be disclosed as a significant accounting principle. While interest revenues and expenses are not normally operating income items, they are for the SRF since making loans is the primary purpose of the program. The statement of cash flows should follow the operating income policies used in the statement of revenues and expenses and changes in fund net assets. The direct method of presenting cash flows from operations should be used, including a reconciliation to operating income.

FUND TYPES AND BASIS OF ACCOUNTING

If GASB 34 is strictly and consistently applied by the states, there will be very few states that do not account for the SRF as proprietary funds. Nonetheless, there may be some SRFs that are not accounted for as proprietary funds, and in those cases, understanding the basis of accounting and type of fund is essential in auditing the SRF financial statements. The type of fund (the measurement focus) determines what transactions and events are recorded and the basis of accounting determines when and how those transactions 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.

⁷ GASB Statement no. 14, *The Financial Reporting Entity*, discusses primary governments and component units. Financial presentation of these entities depends on the circumstances.

⁸ GASB Statement no. 34, paragraph 92.

An important element in achieving these goals is selecting of a basis of accounting and fund type for the SRF that provides the necessary information to meet these goals. The basis of accounting and fund type are intertwined. The basis of accounting used depends on the fund type, and the fund type may determine the basis of accounting. Both will determine the accounting principles applicable to the SRF. GASB 34 has substantial impacts on the fund type for the SRF and the basis of accounting to be used.

Auditors 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 all funds, including the SRF, on the cash basis during the year, and make adjustments to convert to the accrual or modified accrual basis for financial statement presentation to present the financial statements according to GAAP.

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. 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. Accounting and reporting for proprietary funds focuses on the determination of operating income, changes in net assets, financial position, and cash flows.

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 makes the financial statements easier to understand.

One of the more meaningful changes made by GASB no. 34 was to define what operations are required to be accounted for as enterprise funds. The focus of enterprise funds is the determination of net income, changes in net assets, financial position, and cash flows. GASB 34 states⁹:

*Enterprise funds may be used to report any activity for which a fee is charged to external users for goods or services. Activities are **required** to be reported as enterprise funds if any one of the following criteria is met. . .*

⁹

GASB statement no. 34, paragraphs 66 and 67.

a. *The activity is financed with debt that is solely secured by a pledge of the net revenues from fees and charges of the activity*¹⁰.

b. *Laws or regulations require that the activity's costs of providing services, including capital costs (such as depreciation or debt service) be recovered with fees and charges, rather than with taxes or similar revenues.*

c. *The pricing policies of the activity establish fees and charges designed to recover its costs, including capital costs (such as depreciation and debt service).* (Emphasis in original)

The SRF programs meet at least one, if not more (depending on how the program is established), of these requirements. The SRF charges a fee (interest) to external users (borrowers) for goods or services (financing). SRFs that issue revenue bonds, including state match bonds, payable solely from the revenues of the SRF, are required to be enterprise funds. In addition, several states charge a loan fee or administrative fee intended to pay the administrative costs of operating the program, either currently or in the future. These states are now required to account for the SRF as an enterprise fund.

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 also be nonexpendable. A number of states account for SRFs as nonexpendable trusts. The accounting is the same as for enterprise funds. However, GASB 34 reclassifies most nonexpendable trust funds as permanent funds, and are to be included in the basic financial statements as governmental funds, not as proprietary funds. As such, nonexpendable trusts may no longer be appropriate for the SRF.

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, and these states merely continued accounting for the SRF as they did the construction grants program. However, special revenue funds are generally not appropriate for SRF operations because they do not easily allow for recording loans and other assets and liabilities of the SRF. If loan fees are charged to borrowers, GASB 34 requires reporting as an enterprise fund.

General Fund. Use of a general fund to account for a SRF is the least desirable option. However, at least one state has operated its SRF as part of a general fund in the past. The purpose of a general fund is to account for all financial resources of an entity except for those resources that cannot be accounted for in another 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.

¹⁰ Debt secured by net revenues and the full faith and credit of the primary government is not payable solely from fees and charges of the activity, even if the government is not expected to make any payments. Some debt may be secured, in part by a portion of its own proceeds, but should be considered as payable solely from the revenues of the activity.

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.

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. Most governmental entities use all three, as different funds have different reporting needs, and a different measurement focus.

Cash. Under the cash basis, receipts are recorded as revenues, and disbursements are recorded as expenditures¹¹. The balance sheet has only two accounts—cash and fund balance—and the operating statement (income statement) 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:

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

Very few governmental agencies use the full accrual basis because measuring income is not the primary objective of governmental entities. However, most proprietary funds use the accrual method of accounting because measuring the results of operations is the primary objective. GASB 34 requires government-wide financial statements to be prepared using the accrual method of accounting.

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

¹¹ 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.

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 will be available to meet obligations of the current period. The calculation would be made on the principal balance after the last payment, 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.

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 item (or items) cause the financial statements not to be fairly presented, and would make probable that someone relying on the financial information would make a different conclusion if the statements were not misstated. 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 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. 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:

- c The recorded balances exist and are owned by the SRF;
- c The recorded balances are complete and stated at realizable amounts;
- c Balances are properly presented in the financial statements;
- c 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 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 revenues. 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 includes 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 indicate 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, and by five year increments for the remaining balance;

∩ 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.

Fund Equity (Net Assets). GASB 33 and GASB 34 have changed how entities account for and report capital contributions and fund balances. GASB 33 establishes the standards for accounting for nonexchange transactions involving financial or **capital** resources. GASB 33 addresses the timing of when a nonexchange transaction occurs, and when the transaction should be recorded. GASB 34 establishes financial reporting standards for state and local governments, including special-purpose governments. This guide is not an in-depth study or evaluation of either pronouncement, but is to identify relevant portions of both and the standards that apply to the SRF program.

A significant change made by GASB 34 is in reporting net assets/fund equity. Net assets should be shown in three components: invested in capital assets, restricted, and unrestricted. Contributed capital is not to be shown with separate components, such as EPA contributions and state contributions, on the statement of net assets. For the SRF, the most common designations will be restricted net assets, which are amounts to be used for debt service and interest payments and cannot be used for other purposes, and unrestricted.

Nonetheless, auditing fund equity is a critical aspect of SRF audits. It is not possible to determine if fund equity is fairly stated without determining the elements that cause fund equity to change from one year to the next. The specific steps involved will vary depending on each situation. However, common procedures would include:

- ∩ Total EPA capitalization grants awarded;
- ∩ Draws made on each grant;
- ∩ Total loans awarded, outstanding, and principal 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 that should be either in the financial statements or the notes. While GASB 34 does not allow the elements of fund equity to be disclosed on the balance sheet, the elements (contributed capital from EPA, state match contributions, and fund equity) should be disclosed in the footnotes. Additional disclosures will vary depending on the circumstances. GASB 38 may require additional disclosures depending upon the particular situation.

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

The statement of revenues and expenses now includes changes in net assets, not just fund balance. Revenues should be reported by major source, and should identify revenues used as security for revenue bonds. It also distinguishes between operating and nonoperating revenues and expenses, and should report separate totals for operating revenues, operating expenses, and operating income. Nonoperating income should be shown after operating income. Capital contributions should be reported after nonoperating revenues and expenses as a separate line item. Operating income and expenses should be appropriate for the nature of the activity, and should be disclosed as a significant accounting principle. While interest revenues and expenses are not normally operating income items, they are for the SRF since making loans is the primary purpose of the program. The statement of cash flows should follow the operating income policies used in the statement of revenues and expenses and changes in fund net assets. The direct method of presenting cash flows from operations should be used, including a reconciliation to operating income.

Other Accounts. There will likely be other accounts on the balance sheet, such as accrued receivables, investments receivable, 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 judgment in determining specific procedures to apply to all accounts.

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CHAPTER 7 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 should be addressed during the audit. Compliance with these provisions allows EPA to effectively have some assurance over items that they believe are important to the successful management of the program and legislative intent. Since the significance of a particular compliance matter can vary from state to state, professional judgment regarding the extent of compliance testing must be exercised.

BACKGROUND

The compliance auditing necessary to satisfy this objective is very similar to the compliance auditing required by the Single Audit Act, set forth in standards for major programs in OMB Circular A-133 (A-133), and identified in OMB's Compliance Supplement to A-133 (the "Supplement"). In the Supplement, EPA has outlined the compliance requirements that, if not followed, could have a direct and material impact on the SRF programs. This is a higher compliance reporting requirement than required by GAGAS. GAGAS requires that audits of Federal programs be designed to "provide reasonable assurance of detecting material misstatements of financial statements or other financial data resulting from noncompliance with provisions of contracts or grant agreements that have a direct and material effect on the determination of financial statement amounts." Additional reporting requirements are discussed in Chapter 8- Audit Completion and the Auditor's Report.

Specific requirements for the Clean Water SRF and the Drinking Water SRF can be found in Part 4 under the Catalog of Federal Domestic Assistance (CFDA) numbers 66.458 and 66.468, respectively. The Supplement contains 14 areas of compliance requirements, 13 of which may be applicable to the SRF programs. Audit objectives and suggested audit procedures for these areas are included in Part 3 of the Supplement. Additional information on nine of these requirements is addressed in Part 4 of the Supplement and is further discussed later in this Chapter. The OMB guidance also states:

Even though [the compliance matrix] indicates that the compliance requirement applies to the Federal program, it may not apply at a particular non-Federal entity, either because that entity does not have activity subject to that type of compliance requirement or the activity could not have a material effect on a major program.

OMB recommends that auditors should use professional judgment when determining which compliance requirements should be tested.

BUILDING ON THE WORK OF OTHERS

In planning the audit effort to satisfy the compliance audit objective, the auditor should determine 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 workpapers of the A-133 audit should be reviewed. In instances where the A-133 audit was of the prior year, the work and workpapers can still provide valuable insight on 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 or may not be problem areas. Specific compliance requirements that should be addressed in SRF audits are as follows (the designations parallel the OMB Compliance Supplement.)

CLEAN WATER SRF 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 intermunicipal 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 grants). Any interest earned from SRF funds must be deposited in the fund and used for these same activities.

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.*

The SRF may be used for reasonable and allowable costs incurred for administration and management of the SRF program (subject to a limit equaling 4 percent of all capitalization grants received), 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 depends 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).

Recipients must follow procedures to minimize the time elapsing between the transfer of funds from the U.S. Treasury and disbursement.

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 provide 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.

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 Funding the SRFs in Chapter 3) 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 is credited to the SRF and any other program income is used in accordance with program policy.*

Interest earned is to be credited to the SRF to increase the fund. Other income/fees (such as loan fees or administrative fees charged on loans) generated by the operation of the SRF should be evaluated against the requirements of 40 CFR 31.25. EPA has established policies governing the use of program income. Generally, program income generated in the SRF can only be used for allowable purposes, including paying the operating expenses of the SRF.

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. Section 35.3150). The state must prepare an Intended Use Plan identifying the intended uses of funds of the SRF, and describe 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. An IUP that adequately describes the use of existing SRF funds as well as those being applied for must be submitted before a capitalization grant can be awarded.
2. Annual Report (40 CFR. Section 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 Section 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 their project 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 Section 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).

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. Section 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. Section 35.3120(d)). Net proceeds are defined as the funds raised from the sale of the bonds minus issuance costs.

DRINKING WATER SRF COMPLIANCE REQUIREMENTS

A. Allowability for Specific Activities.

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

The DWSRF may provide financial assistance: (1) to privately-owned and publicly-owned community water systems and non-profit noncommunity water systems, (2) projects that will result in the creation of a community water system and, (3) systems referred to in section 1401 (4)(B) of the Safe Drinking Water Act for purposes of point of entry or central treatment under section 1401(4)(B)(i)(III).

Projects that address present or prevent future violations of health-based drinking water standards are eligible for assistance, which includes projects needed to maintain compliance with existing national primary drinking water regulations for contaminants with acute and chronic health effects. The following project categories are eligible for assistance:

1. Treatment facilities;
2. Transmission and distributions facilities;
3. Source water projects such as the rehabilitation of wells or development of eligible sources to replace contaminated sources;
4. Storage facilities;
5. Consolidation of water supplies; and
6. Creation of new community water systems to address existing public water health problems.

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

1. Loans;
2. Loan subsidies to disadvantaged communities. Subsidies can include full or partial principal forgiveness, negative interest rates, extension of the loan repayment period to 30 years (provided that the repayment term does not exceed the expected useful life of the project), or a combination of the above;
3. Refinance or purchase local debt obligations for projects initiated after July 1, 1993;
4. Purchase insurance for or guarantee local debt obligations;
5. Use revenues or otherwise provide security for debt obligations of the loan fund, provided the net proceeds of the sale of the debt obligations are deposited into the loan fund and used to provide assistance eligible under the Act.

States may also use a portion of its capitalization grants for set-aside activities. These uses and limitations of these activities are covered in section B, **Allowable Costs/Cost Principles.**

B. Allowable Costs/Cost Principles.

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

The uses of set-asides from the capitalization grant are:

1. 4 percent to administer the DWSRF program and provide technical assistance to public water systems;
2. 2 percent of to provide technical assistance to small public water systems;
3. 10 percent for state program management activities, including administration of the State Public Water System Supervision Program, administration of the source water protection program, development and implementation of the capacity development and operator certification programs;
4. 15 percent to assist in the development and implementation of local drinking water protection initiatives and other State programs.

C. Cash Management.

Audit Objective: *To determine that the state has drawn cash consistent with the DWSRF 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 DWSRF 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 and other set-aside expenses - cash can be drawn based on a schedule that coincides with the rate at which administrative expenses will be incurred (40 CFR 35.3560(e)).

Recipients must follow procedures to minimize the time elapsing between the transfer of funds from the U.S. Treasury and disbursement.

G. State Matching.

Audit Objective: *To determine that the state provides the required matching funds in a timely manner.*

States are required to deposit into the SRF a match of at least twenty (20) percent of each capitalization grant payment made. If the State uses a letter of credit or similar instrument, they may deposit the

proportionate share of match on or before the date an EPA cash draw is received. The proportionate share of state match is equal to the State match required for the SRF divided by the total amount of monies intended for the SRF (capitalization grant minus set-asides plus State match). The matching can be made by direct appropriation, general obligation bonds, revenue bonds, or other methods.

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 Funding the DWSRF in Chapter 3) 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 35.3550(d)]. Cash draw requirements are discussed at 40 CFR 35.3560. States must enter into **cumulative** binding commitments of at least the amount of the cumulative capitalization grant payments for the SRF (excludes set-aside funds) received one year earlier and the corresponding state match required to be deposited into the loan fund.

J. Program Income

Audit Objective: *To determine that interest earned is credited to the loan fund and any other program income is used in accordance with DWSRF regulations.*

Interest earned is to be credited to the loan fund. Other income/fees generated by the operation of the DWSRF should be evaluated against the requirements of 40 CFR 35.3530(b) and 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 35.3555). The state must prepare an Intended Use Plan identifying the intended uses of funds of the DWSRF, and describing how those uses support the goals of the DWSRF. An IUP that adequately describes the use of existing SRF funds as well as those being applied for must be submitted before a capitalization grant can be awarded.
2. Biennial Report [40 CFR 35.3570(a)]. The state must provide a biennial report to the EPA Regional Administrator describing how it has met the goals and objectives of the previous two fiscal years as stated in the IUPs and capitalization grants. These biennial reports should contain the most recent audit of the Fund and the entire State allotment. The state must establish in the biennial report that it has complied with section 1452 of the Act, including that the state has (1) managed the DWSRF program in a fiscally prudent manner, (2) deposited its match into the Fund, (3) made binding commitments with recipients consistent with the requirements, (4) funded only the highest priority projects listed in the IUP or document why priority projects were bypassed, (5) provided assistance only to eligible public water systems for eligible projects and project-related costs, (6) provided set-aside assistance only as eligible under section 35.3535 and consistent with workplans and other requirements, (7) provided loan assistance to small communities consistent with 35.3525(a)(5) and 35.3555(c)(2)(iv), provided assistance to disadvantaged communities consistent with 35.3535(b) and 35.3555(c)(7), (8) Adopted and implemented procedures consistent with the requirements of § 35.3530(c) and § 35.3555(c)(8) if funds were

transferred between the DWSRF program and CWSRF program, (9) reviewed all DWSRF program funded projects and activities for compliance with Federal crosscutters, (10) reviewed all DWSRF program funded projects and activities in accordance with approved State environmental review procedures under 35.3580; and (11) complied with general grant regulations at 40 CFR part 31.

M. Subrecipient Monitoring.

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

The state must require recipients of DWSRF 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 35.3580 before loan recipients initiate construction under projects.*

The state must conduct reviews of the potential environmental impacts of all construction projects receiving assistance from the DWSRF

Fund Establishment:

Audit Objective: *To determine that the state has established proper accounts and accounting procedures that are sufficient to assure proper accounting for DWSRF transactions and balances, including the loan fund and all set-aside funds.*

The state is to establish the DWSRF and the set-asides as a separate account or series of accounts dedicated solely to providing financial assistance in the form of loans and other eligible assistance. The state must establish fiscal controls and accounting procedures that are sufficient to measure (1) revenues earned and other receipts, including but not limited to, loan repayments, capitalization grants, interest earnings, state match deposits, and net bond proceeds; (2) expenses incurred and other disbursements, including but not limited to, loan disbursements, repayments of bonds, and other expenditures allowed under section 1452 of the Act; (3) assets, liabilities, capital contributions and retained earnings.

Loan Repayments and Fund Earnings Credited to DWSRF:

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

All loan repayments, including principal and interest, and interest earnings on investments, must be credited directly to the DWSRF. 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 35.3525]. Loans to disadvantaged communities may be repaid over 30 years, or the estimated useful life of the project, whichever is shorter.

DWSRF as Security for Bonds:

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

If a state uses the DWSRF 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 DWSRF. Net proceeds are defined as the funds raised from the sale of the bonds minus issuance costs.

CHAPTER 8 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, *Client Representations*, provides guidance to assist the auditor in the content and timing of representations.

Normally, the auditor prepares the representation for management to sign, and works 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. It 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. Management's refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion.

A sample representation letter is included as Appendix E.

PRESENTING THE RESULTS OF AUDIT

In accordance with GAGAS and OIG 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 preliminary exit conference to convey the tentative results of audit.

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, and 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 control 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 is also transmitted to EPA for resolution of audit findings. Reports on compliance and internal controls may be separate or combined. The auditor should decide which format is appropriate under the circumstances.

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

Reports on Compliance. A major aspect of EPA's oversight of the SRF programs is to determine if states have complied in all material respects with laws, regulations, and the provisions of SRF capitalization grants. Reports on compliance allow EPA to receive some assurance that states are complying with matters that are important to the successful management of the program.

GAGAS requires that audits of Federal programs be designed to "provide reasonable assurance of detecting material misstatements of financial statements or other financial data resulting from noncompliance with provisions of contracts or grant agreements that have a direct and material effect on the determination of financial statement amounts." While GAGAS requires auditors to report the scope of the testing of compliance with laws and regulations and of internal controls when performing financial statement audits, the 2002 Revision (Exposure Draft) states:

Auditors should report the scope of their testing of compliance with laws and regulations and of internal control over financial reporting, including whether or not the tests they performed provide sufficient evidence to support an opinion on compliance with laws and regulations or internal control over financial reporting and whether they are providing such opinions.

Auditors had been able to disclaim opinions on compliance because the objective of an audit was to express an opinion on the financial statements, not on compliance with applicable laws, regulations, contracts, and grant provisions.

However, this guide establishes that one of the principal objectives of auditing the SRF is to determine if the state complied with the compliance requirements. As such, disclaimers of opinion on compliance are not acceptable. Opinions on compliance must be unqualified, qualified, or an adverse opinion. 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 that 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 could also include irregularities and other illegal acts. When material instances of noncompliance are discovered, the report should include:

- c Identification of the material noncompliance noted;
- c 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;
- c Identify and question any costs as a result of the noncompliance.

This guide establishes the reporting requirements for audits of SRFs, and AICPA standards require that reporting for program-specific audits follow the reporting requirements of program-specific 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 reporting requirements of A-133.

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

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

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Appendix A

Reference Material

SRF Program

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

Safe Drinking Water Act Amendments of 1996 (Title I)

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

40 CFR Part 35, Subpart L - Drinking Water State Revolving Funds

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

EPA's Guide to Using EPA's Automated Clearing House for the Drinking Water State Revolving Fund Program, September 1998 (available for download at www.epa.gov)

SRF Correspondence¹²

Professional Audit Pronouncements

Government Auditing Standards, 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

OMB Circular No. A-133

OMB Circular No. A-133 Compliance Supplement, March 2002

¹² 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 B

Sample Engagement Letter

Date

Addressee

Re: Audit of Financial Statements of State Revolving Fund

Dear :

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

- ∩ express an opinion on the fairness of the financial statements prepared by the State of XXXXXX, 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 that includes 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 applicable in the United States 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 XXXXXX.

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]**;

- c Copies of the state legislation establishing the SRF, operating agreements, memorandums of understanding with other departments or agencies;
- c Copies of all capitalization grant agreements, including amendments, awarded by the Environmental Protection Agency through **[balance sheet date]**;
- c Access to minutes of the Board, and;
- c An organization chart of the SRF, plus job descriptions for all personnel.

We will also require that you prepare several confirmations letters that we can use to confirm loans, cash in the state treasury, attorney's letters, and a representation letter.

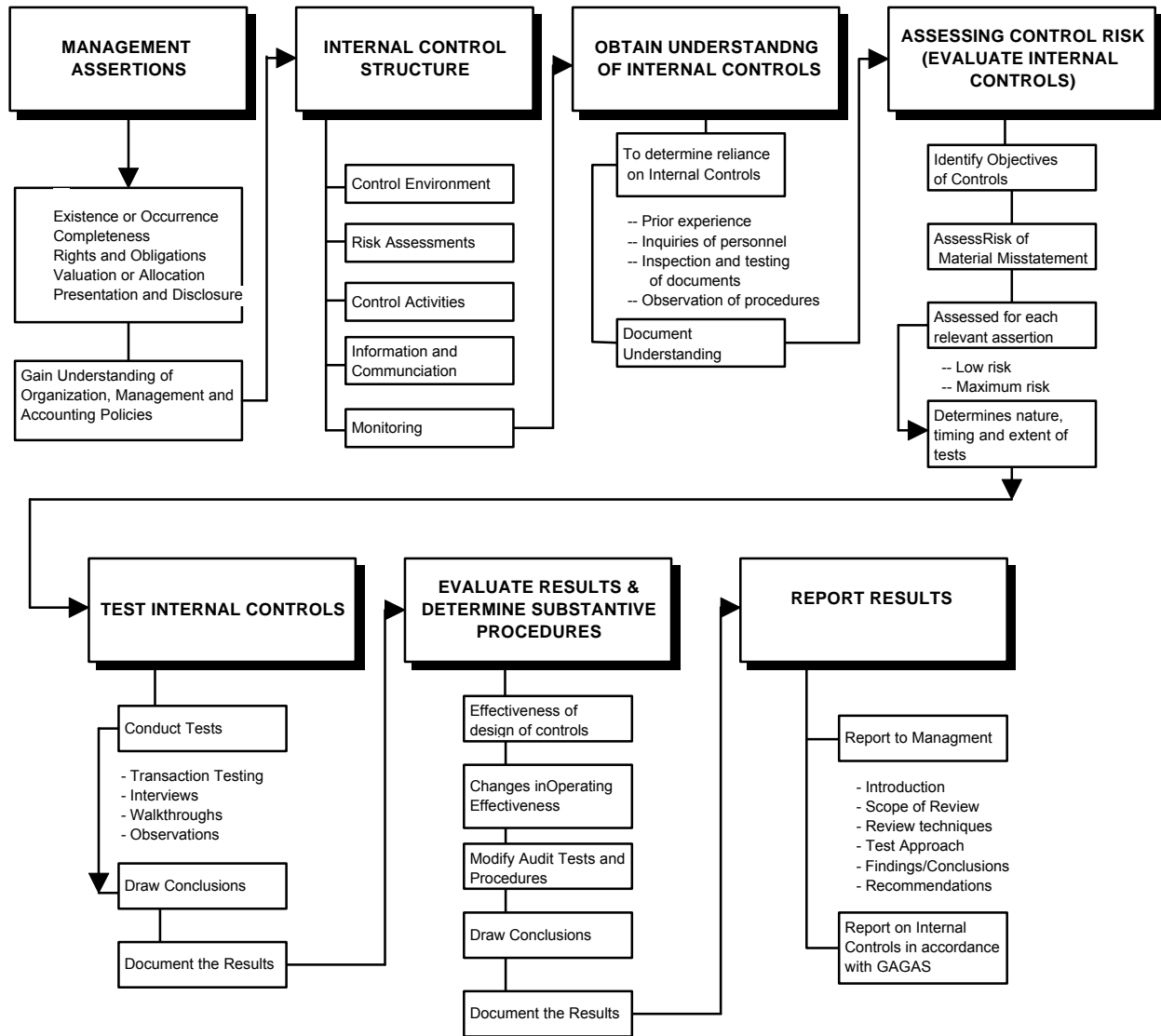
If you should have any questions, please contact me at (999) 999-9999 or **[Supervisor/AIC]** at (999) 999-9998.

Sincerely,

Appendix C

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 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.

Financial Statement Assertions and Potential Misstatements

ASSERTION	POTENTIAL MISSTATEMENT	CONTROL OBJECTIVE
<p>Existence or Occurrence</p>	<p><u>Transaction-Related</u></p> <p>Validity: 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>Summarization: 3. Transactions are summarized improperly, resulting in an overstated total.</p> <p><u>Line Item/Account-Related</u></p> <p>Substantiation: 4. Recorded assets and liabilities do not exist at a given date</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>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>

ASSERTION	POTENTIAL MISSTATEMENT	CONTROL OBJECTIVE
<p>Completeness</p>	<p><u>Transaction-Related</u></p> <p>Transaction Completeness: 5. Valid transactions are not recorded.</p> <p>Cutoff: 6. Economic events occur in the current period, but the related transactions are recorded in a different period.</p> <p>Summarization: 7. Transactions are summarized improperly, resulting in an understated total.</p> <p><u>Line Item/Account-Related</u></p> <p>Account Completeness: 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>
<p>Valuation or Allocation</p>	<p><u>Transaction-Related</u></p> <p>Accuracy: 9. Transactions are recorded at incorrect amounts.</p> <p><u>Line Item/Account-Related</u></p> <p>Valuation: 10. Assets and liabilities included in the financial statements are valued on an inappropriate basis.</p> <p>Measurement: 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>

ASSERTION	POTENTIAL MISSTATEMENT	CONTROL OBJECTIVE
Rights and Obligations	<p><u>Line Item/Account-Related</u></p> <p>Ownership: 12. Recorded assets are owned by others because of sale, consignment, or other contractual arrangements.</p> <p>Rights: 13. The entity does not have certain rights to recorded assets because of liens, pledges, or other restrictions.</p> <p>Obligations: 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>
Presentation and Disclosure	<p><u>Line Item/Account-Related</u></p> <p>Account Classification: 15. Accounts are not properly classified and described in the financial statements.</p> <p>Consistency: 16. The financial statement components are based on accounting principles different from those used in prior periods.</p> <p>Disclosure: 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>
See Note Below	<p><u>Transaction-Related</u></p> <p>Segregation of Duties: 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

Sample Representation Letter

(On auditee letterhead)

[Date of Audit Report]

To

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 XXXXXX 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 XXXXXX 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 XXXXXX 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 F

Sample Financial Statements

Note: The following financial statements are intended to be as guides for reporting SRF operations. The format of these examples do not encompass all possible reporting needs for every state. Considerable judgment in presentation is required.

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Appendix F-1: Direct loan program, without administrative fund.

Sample State
Water Pollution Control Revolving Fund

Financial Statements with
Independent Auditor's Report

June 30, 2XXX

**Sample State
Water Pollution Control Revolving Fund**

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Independent Auditor's Report on Compliance with the Requirements Applicable to the Environmental
Protection Agency's State Revolving Fund Program in Accordance with
Government Auditing Standards 15

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 June 30, 2XXX, and the related statements of revenues, expenses and changes in net assets, 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.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and 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.

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.

The scope of our audit 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 June 30, 2000 or the related statements of revenue, expenses and changes in fund balance, 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 June 30, 2XXX 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 Protection, 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 September 15, 2XXX, on our consideration of the Sample State Water Pollution Control Revolving Fund's internal control structure and a report dated September 15, 2XXX on its compliance with laws and regulations.

Firm Name
Location
September 15, 2XXX

**Sample State
WATER POLLUTION CONTROL REVOLVING FUND**

**Balance Sheet
June 30, 2XXX
With Unaudited Comparative Totals for 2XXY
(in thousands)**

Assets	2XXX	Unaudited 2XXY
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>
 Liabilities and Net Assets		
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>
 Net assets	 <u>532,589</u>	 <u>429,089</u>
 Total liabilities and net assets	 <u>\$ 533,307</u>	 <u>\$ 433,755</u>

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

**Sample State
WATER POLLUTION CONTROL REVOLVING FUND**

**Statement of Revenues, Expenses and Changes in Net Assets
For the year ended June 30, 2XXX
With Unaudited Comparative Totals for 2XXY
(in thousands)**

	2XXX	Unaudited 2XXY
Revenues:		
Interest on loans	\$ 11,943	\$ 8,423
Investment income	4,513	2,951
Total revenues	16,456	11,374
Expenses:		
Administrative expenses	2,664	2,637
Operating income	13,792	8,737
Non-operating income:	81,707	
EPA capitalization grant	8,001	73,686
Sample State contribution	103,500	22,148
Change in net assets		104,571
Net assets, beginning of year	429,089	325,238
Net assets, end of year	\$ 532,589	\$ 429,089

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

Sample State
WATER POLLUTION CONTROL REVOLVING FUND

Statement of Cash Flows
For the year ended June 30, 2XXX
With Unaudited Comparative Totals for 2XXY
(in thousands)

	<u>2XXX</u>	<u>Unaudited 2XXY</u>
Cash flows from operating activities:		
Operating income	\$ 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 noncapital 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 noncapital 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.

Sample State
WATER POLLUTION CONTROL REVOLVING FUND
Notes to Financial Statements
June 30, 2XXX
(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 June 30, 2XXX, 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.

2. Summary of Significant Accounting Policies

Basis of Accounting

The Fund presents its financial statements as an proprietary (enterprise) 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.

Sample State
WATER POLLUTION CONTROL REVOLVING FUND
Notes to Financial Statements
June 30, 2XXX
(in thousands)

2. Summary of Significant Accounting Policies (continued)

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.

Capitalization Grants

In accordance with generally accepted accounting principles, funds received from the EPA and the State for the capitalization of the Fund are recorded as non-operating revenues. 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.

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 2XXY unaudited financial statements have been reclassified to conform to the presentation in the 2XXX financial statements.

Sample State
WATER POLLUTION CONTROL REVOLVING FUND
Notes to Financial Statements
June 30, 2XXX
(in thousands)

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, 2XXX, 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, 2XXX was approximately \$12.1 billion, and total earnings for the year ended June 30, 2XXX 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, 2XXX 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 June 30, 2XXX are:

Loans by Category:

Loans receivable at June 30, 2XXX, 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, June 30, 2XXX			<u>\$ 410,834</u>

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

Sample State
WATER POLLUTION CONTROL REVOLVING FUND
Notes to Financial Statements
June 30, 2XXX
(in thousands)

4. Loans Receivable (continued)

Year ending June 30:	<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 2XXX, 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.

As of June 30, 2XXX, 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 <u>Authorized</u>	Funds <u>Disbursed</u>	Unamortized Loan Origination Fee	Loan <u>Balance</u>
Completed projects	\$ 3,869	\$ 3,869	\$ 595	\$ 3,274
Projects in progress	<u>12,402</u>	<u>4,956</u>	<u>941</u>	<u>4,015</u>
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 June 30, 2XXX.

Loans to Major Local Agencies

As of June 30, 2XXX, 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:

Sample State
WATER POLLUTION CONTROL REVOLVING FUND
Notes to Financial Statements
June 30, 2XXX
(in thousands)

4. Loans Receivable (continued)

<u>Local Agency</u>	<u>Authorized Loan Amount</u>	<u>Outstanding Balance</u>
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	<u>11,305</u>	<u>8,191</u>
 Total	 <u>\$ 421,176</u>	 <u>\$ 347,003</u>

The authorized loan amount includes both completed projects and projects in progress. As of June 30, 2XXX, 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.

5. Fund Equity

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 non-operating revenues from the Environmental Protection Agency and Sample State. As of June 30, 2XXX, 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:

<u>Year</u>	<u>Grant Amount</u>	<u>Total Draws June 30, 2XXY</u>	<u>2XXX Draws</u>	<u>Total Draws June 30, 2XXX</u>	<u>Available June 30, 2XXX</u>
Pre1994	\$ 76,547	\$ 76,496	\$ 18	\$ 76,514	\$ 33
1995	71,866	69,501	945	70,446	1,420
1996	88,067	82,706	3,901	86,607	1,460
1997	83,377	64,930	15,970	80,900	2,477
1998	82,479	27,675	23,393	51,068	31,411
1999	51,177	1,393	25,299	26,692	24,485
1999	52,855	0	7,181	7,181	45,674
2XXY	86,578	0	5,000	5,000	81,578
2XXX	<u>34,095</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>34,095</u>
 Totals	 <u>\$ 627,041</u>	 <u>\$ 322,701</u>	 <u>\$ 81,707</u>	 <u>\$ 404,408</u>	 <u>\$ 222,633</u>

5. Fund Equity (continued)

As of June 30, 2XXY and 2XXX, State matching contributions were:

	<u>June 30, 2XXY</u>	<u>2XXX Contribution</u>	<u>June 30, 2XXX</u>
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 June 30, 2XXX, 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.

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.

**Independent Auditor's Report on the
Internal Control Structure Based on an
Audit of the Financial Statements
Performed In Accordance with
Government Auditing Standards**

Sample State Water Pollution Control Revolving Fund

We have audited the financial statements of the State Water Pollution Control Revolving Fund as of and for the year ended June 30, 2XXX, and have issued our report thereon dated September 15, 2XXX.

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.

The management of the State Water Pollution Control Revolving Fund is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgements by management are required to assess the expected benefits and related costs of internal control policies and procedures. 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 or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In planning and performing our audit of the financial statements of the State Water Pollution Control Revolving Fund for the year ended June 30, 2XXX, 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 established 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.

This report is intended for the information of management of the State Water Pollution Control Revolving Fund and the United States Environmental Protection Agency. However, this report is a matter of public record and distribution is not limited.

Firm
City

September 15, 2XXX

**Independent Auditor's Report
on Compliance with the Requirements Applicable to the
Environmental Protection Agency's
State Revolving Fund Program
in Accordance with
Government Auditing Standards**

Sample State Water Pollution Control Revolving Fund

We have audited the financial statements of the Sample State Water Pollution Control Revolving Fund (the Fund) as of and for the year ended June 30, 2XXX, and have issued our report thereon dated September 15, 2XXX

We have also audited the Fund's compliance with requirements governing:

- c Allowability for Specific Activities;
- c Allowable Costs/Cost Principles;
- c Cash Management;
- c State Matching;
- c Period of Availability of Funds and Binding Commitments;
- c Program Income;
- c Reporting;
- c Subrecipient Monitoring, and;
- c Special tests and provisions;

that are applicable to its major Federal financial assistance program for the year ended June 30, 2XXX. The management of the State Water Pollution Control Revolving Fund is responsible for the Fund's compliance with those requirements. Our responsibility is to express an opinion on those requirements based on our audit.

We conducted our audit of compliance with those requirements in accordance with generally accepted auditing standards, *Government Auditing Standards*, issued by the Comptroller General of the United States, and the *Environmental Protection Agency State Revolving Fund Audit Guide*. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether material noncompliance with the requirements referred to above occurred. An audit includes examining, on a test basis, evidence about the Fund's compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the State Water Pollution Control Revolving Fund complied, in all material respects, with the requirements governing types of service and types of costs allowed or unallowed; matching, level of effort or earmarking requirements; special reporting requirements; special tests and provisions; and claims for advances and reimbursements that are applicable to its major Federal financial assistance program for the year ended June 30, 2XXX.

This report is intended for the information of management of the Fund and the United States Environmental Protection Agency. However, this report is a matter of public record and its distribution is not limited.

Firm
City

September 15, 2XXX

Appendix F-2: Direct loan program with administrative fee fund.

**Sample State
WATER POLLUTION CONTROL REVOLVING FUND
Combining Balance Sheet
June 30, 2XXX
With Unaudited Comparative Totals for 2XXY
(in thousands)**

<u>Assets</u>	<u>Loan Fund</u>	<u>2XXX Administration</u>	<u>Total</u>	<u>2XXY (Unaudited)</u>
Current Assets:				
Cash and cash equivalents	\$ 101,082	\$ 6,010	\$ 107,092	\$ 72,866
Receivables:				
Interest on loans	2,693		2,693	2,284
Interest on investments	1,254		1,254	997
Other	<u>1,206</u>		<u>1,206</u>	<u>3,364</u>
Total receivables	5,153		5,153	6,645
Current maturities of loans receivable	<u>16,238</u>		<u>16,238</u>	<u>14,378</u>
Total current assets	<u>122,473</u>	<u>6,010</u>	<u>128,483</u>	<u>93,889</u>
Loans receivable, net	<u>410,834</u>		<u>410,834</u>	<u>345,031</u>
Total assets	<u>533,307</u>	<u>6,010</u>	<u>539,317</u>	<u>\$ 438,920</u>
<u>Liabilities and Net Assets</u>				
Current liabilities:				
Accounts payable and accrued expenses	184	73	257	272
Construction costs payable	516		516	4,414
Other	<u>18</u>		<u>18</u>	<u>30</u>
Total current liabilities	<u>718</u>	<u>73</u>	<u>791</u>	<u>4,716</u>
Net assets	<u>532,589</u>	<u>5,937</u>	<u>538,526</u>	<u>434,204</u>
Total liabilities and net assets	<u>\$ 533,307</u>	<u>\$ 6,010</u>	<u>\$ 539,317</u>	<u>\$ 438,920</u>

**Sample State
WATER POLLUTION CONTROL REVOLVING FUND**

**Combining Statement of Revenues, Expenses and Changes in Fund Net Assets
For the year ended June 30, 2XXX
With Unaudited Comparative Totals for 2XXY
(in thousands)**

	<u>Loan Fund</u>	<u>2XXX Administration</u>	<u>Total</u>	<u>2XXY (Unaudited)</u>
Revenues:				
Interest on loans	\$ 11,943		\$ 11,943	\$ 8,423
Investment income	4,513	\$ 1,578	6,091	4,294
Loan fees		<u>328</u>	<u>328</u>	<u>258</u>
Total revenues	<u>16,456</u>	<u>1,906</u>	<u>18,362</u>	<u>12,975</u>
Expenses:				
Salaries and benefits	2,630	992	3,695	3,342
Other expenses	<u>34</u>	<u>19</u>	<u>53</u>	<u>69</u>
Total operating expenses	<u>2,664</u>	<u>1,011</u>	<u>3,748</u>	<u>3,411</u>
Operating income	13,792	895	14,614	9,654
Non-operating income:				
EPA capitalization grant	81,707		81,707	73,686
Sample State contribution	<u>8,001</u>		<u>8,001</u>	<u>22,148</u>
Change in fund equity	103,500	895	104,322	105,398
Net assets, beginning of year	<u>429,089</u>	<u>5,115</u>	<u>434,204</u>	<u>328,806</u>
Net assets, end of year	<u>\$ 532,589</u>	<u>\$ 6,010</u>	<u>\$ 538,526</u>	<u>\$ 429,089</u>

Sample State
WATER POLLUTION CONTROL REVOLVING FUND

Combined Statement of Cash Flows
For the year ended June 30, 2XXX
With Unaudited Comparative Totals for 2XXY
(in thousands)

	<u>2XXX</u>	<u>2XXY</u> <u>(Unaudited)</u>
Cash flows from operating activities:		
Cash received from customers	\$ 26,949	\$ 19,057
Cash payments to borrowers	(79,679)	(79,804)
Cash payments to employees and suppliers	(3,713)	(3,363)
Interest received on investments	5,834	4,112
Other	<u>(6,157)</u>	<u>(15,723)</u>
Net cash used by operating activities	<u>(57,066)</u>	<u>(75,721)</u>
Cash flows from noncapital and related financing activities:		
Funds received from EPA	81,707	73,686
Funds received from the Sample State	<u>8,001</u>	<u>22,148</u>
Net cash provided by noncapital and related financing activities	<u>91,292</u>	<u>95,834</u>
Increase in cash and cash equivalents	34,226	20,113
Cash and cash equivalents, beginning of year	<u>72,866</u>	<u>52,753</u>
Cash and cash equivalents, end of year	<u>\$ 107,092</u>	<u>\$ 72,866</u>
Cash flows from operating activities:		
Operating income	\$ 14,614	\$ 8,737
Adjustments to reconcile operating income to net cash flow provided by operations:		
Changes in assets and liabilities:		
(Increase) decrease in accounts receivable	(368)	(3,975)
Increase (decrease) in accounts payable and accrued expenses	(3,925)	(30)
Deferred income recognized	(48)	
Loan disbursements	(81,717)	(92,396)
Loan principal repayments	<u>14,378</u>	<u>11,116</u>
Net cash used by operating activities	<u>\$ (57,066)</u>	<u>\$ (75,721)</u>

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Appendix F-3: Direct loan program, state match provided by SRF revenue bonds.

**Sample State
Clean Water State Revolving Fund
Balance Sheet
June 30, 2XXX and 2XXY**

	<u>2XXX</u>	<u>2XXY</u>
Cash and cash equivalents	\$ 73,545,494	\$ 62,737,151
Short-term investments	4,344,075	2,287,710
Current receivables:		
Loan interest	630,223	733,154
Investment interest	236,233	46,141
Current portion of loans receivable	<u>6,913,742</u>	<u>20,442,282</u>
Total current receivables	7,780,198	1,521,577
Loans receivable:	109,507,111	95,242,454
Issuance costs, net	<u>42,322</u>	<u>16,676</u>
Loans receivable, net	<u>109,549,433</u>	<u>95,259,130</u>
 Total assets	 <u>195,219,200</u>	 <u>181,805,568</u>
Liabilities and Equity:		
Current liabilities:		
Bond Interest Payable	39,235	23,040
Current Portion of Bonds Payable	<u>2,300,000</u>	<u>2,295,000</u>
Total current liabilities	<u>2,339,235</u>	<u>2,318,040</u>
Long-term Liabilities:		
Bonds Payable	2,045,000	1,190,000
Unamortized premium (discount)	<u>6,090</u>	<u>(7,317)</u>
Total Liabilities	<u>4,390,325</u>	<u>3,500,723</u>
Net assets	<u>190,828,875</u>	<u>178,304,845</u>
Total liabilities and net assets	<u>\$ 195,219,200</u>	<u>\$ 181,805,568</u>

**Sample State
Clean Water State Revolving Fund
Income Statement
For the years ended June 30, 2XXX and 2XXY**

	<u>2XXX</u>	<u>2XXY</u>
Operating revenues:		
Loan interest	\$ 2,419,031	\$ 2,219,654
Investment income	3,520,712	3,843,596
Other	<u> </u>	<u>151,331</u>
Total operating revenues	5,939,743	6,214,581
Operating expenses:		
Salaries and benefits	220,545	207,852
Interest expense	181,444	163,589
Amortization of bond issuance costs	15,165	10,617
Indirect costs	<u>1,401</u>	<u>1,500</u>
Total operating expenses	<u>418,555</u>	<u>383,558</u>
Operating income	<u>5,521,188</u>	<u>5,831,023</u>
Capital contributions-Federal grants	<u>7,002,842</u>	<u>4,711,102</u>
Change in net assets	12,524,030	10,542,125
Net assets, beginning of year	<u>178,304,845</u>	<u>167,762,720</u>
Net assets, end of year	<u><u>\$190,828,875</u></u>	<u><u>\$178,304,845</u></u>

**Sample State
Clean Water State Revolving Fund
Statements of Cash Flows
For the years ended June 30, 2XXX and 2XXY**

	<u>2XXX</u>	<u>2XXY</u>
Cash flows from operating activities:		
Cash received from customers	\$ 35,320,945	\$ 26,267,955
Cash payments to borrowers	(33,535,100)	(44,197,061)
Cash payments to employees for services	(200,057)	(211,812)
Other	(183,358)	(46,442)
Interest on investments	<u>3,630,620</u>	<u>3,998,998</u>
Net cash (used) by operating activities	5,033,050	(14,188,362)
Cash flows from noncapital and related financing activities:		
Funds received from Environmental Protection Agency	7,002,842	4,975,356
Purchase of investments	(2,056,365)	(2,284,060)
Proceeds from revenue bonds	4,304,168	2,294,940
Principal paid on debt	<u>(3,475,352)</u>	<u>(2,245,000)</u>
Net cash provided by noncapital and related financing activities	<u>5,775,293</u>	<u>2,741,236</u>
Increase in cash and cash equivalents	10,808,343	(11,447,126)
Cash and cash equivalents, beginning of year	<u>62,737,151</u>	<u>74,184,277</u>
Cash and cash equivalents, end of year	<u>\$73,545,494</u>	<u>\$ 62,737,151</u>
Reconciliation of operating income to cash provided by operations:		
Revenues over expenses	\$ 5,521,188	\$ 5,831,023
Adjustments to reconcile operating income to net cash provided by operating activities:		
Amortization of bond issuance costs	18,945	16,407
(Increase) Decrease in accounts receivable	212,839	(86,723)
Increase (Decrease) in accounts payable and accrued expenses	16,195	(26,054)
Net increase in loans	<u>(736,117)</u>	<u>(19,923,015)</u>
Net cash provided by operating activities	<u>\$ 5,033,050</u>	<u>\$ (14,188,362)</u>

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Appendix F-4:

Leveraged loan program.

Sample State
WATER POLLUTION CONTROL REVOLVING FUND
Balance Sheet
June 30, 2XXX

<u>Assets</u>	
Current assets:	
Cash and cash equivalents	\$ 5,848,935
Receivables:	
Interest receivable	378,167
Due from Federal government	803,931
Current portion of loans receivable	<u>1,442,490</u>
Total current assets	<u>8,473,523</u>
Restricted assets-cash and cash equivalents	7,439,733
Non-current assets:	
Loans receivable	32,728,067
Equipment, net	173,958
Other	<u>74,397</u>
Total non-current assets	<u>32,976,422</u>
Total assets	<u><u>48,889,678</u></u>
<u>Liabilities and Net Assets</u>	
Liabilities	
Current liabilities:	
Accounts payable	345,299
Due to other funds	458,633
Bond interest	57,348
Other	120,443
Current portion of bonds payable	<u>1,102,500</u>
Total current liabilities	<u>2,084,223</u>
Non-current liabilities-Bonds payable, net of discounts	<u>5,600,740</u>
Total liabilities	<u>7,684,963</u>
Net assets:	
Invested in capital assets, net of debt	173,958
Restricted for loans and debt service	41,151,200
Unrestricted (deficit)	<u>(120,443)</u>
Total	<u>41,204,715</u>
Total liabilities and net assets	<u><u>\$ 48,889,678</u></u>

Sample State
WATER POLLUTION CONTROL REVOLVING FUND
Statement of Revenues, Expenses and Changes in Fund Net Assets
June 30, 2XXX

Operating revenues:	
Loan interest	\$ 753,753
Investment interest	341,526
Federal grants	<u>3,565,526</u>
Total operating revenues	<u>4,660,805</u>
Operating expenses:	
Salaries and benefits	1,429,653
Professional services	1,534,917
Travel	70,926
Office	40,125
Equipment	237,563
Depreciation and amortization	121,919
Interest expense	51,945
Other	<u>289,664</u>
Total operating expenses	<u>3,776,712</u>
Operating income	884,093
Non-operating revenue:	
Federal grant	20,007,098
State contribution	<u>3,571,346</u>
Total non-operating revenue	<u>23,578,444</u>
Increase in net assets	24,462,537
Net assets, beginning of year	<u>16,742,178</u>
Net assets, end of year	<u>\$ 41,201,715</u>

Sample State
WATER POLLUTION CONTROL REVOLVING FUND
Statement of Cash Flows
June 30, 2XXX

Cash flows from operating activities:	
Interest received on loans	\$ 499,167
Interest paid on bonds	(50855)
Federal grant-administration	3,402,975
Payments to employees	(1,392,206)
Payments to suppliers	(2,010,770)
Investment income	<u>241,527</u>
Cash provided by operating activities	<u>789,838</u>
Cash flows from noncapital financing activities:	
Federal grants	20,007,098
State contributions	3,571,346
Bonds issued	6,703,239
Bond issuance costs	<u>(74,397)</u>
Net cash provided by noncapital financing activities	<u>30,207,286</u>
Cash flows from investing activities:	
Loans to governments	(27,646,223)
Principal repayments	<u>6,427,500</u>
Net cash used in investing activities	<u>(21,218,723)</u>
Net increase in cash and cash equivalents	9,778,401
Cash and cash equivalents, beginning of year	<u>3,510,267</u>
Cash and cash equivalents, end of year	<u>\$ 13,288,668</u>
Reconciliation of net operating income to net cash provided by operating activities:	
Operating income	\$ 884,093
Adjustments to reconcile net operating income to net cash provided by operations:	
Depreciation and amortization	121,919
Changes in assets and liabilities:	
(Increase) in current assets	(417,137)
Increase in current liabilities	<u>200,963</u>
Net cash provide by operating activities	<u>\$ 789,838</u>

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Appendix F-5: Drinking Water Statement of Revenues and Expenses, with supplementary information on Set-Aside expenses.

**Sample State
Drinking Water State Revolving Fund
Statement of Revenue, Expense and Change in Net Assets
For the Year Ended June 30, 2XXX**

	Loan Fund	Loan Fee Fund	Total
Operating revenues:			
Interest on investments	\$ 739,776	\$ 36,197	\$ 775,973
Interest on loans	682,707		682,707
Administrative Fees		471,821	471,821
EPA Set-aside Operating Grants	<u>4,537,157</u>	<u> </u>	<u>4,537,157</u>
Total operating revenues	5,959,640	508,018	6,467,658
Operating Expenses			
Administration	622,686		622,686
Technical Assistance	473,852		473,852
Program Management	1,369,416		1,369,416
Local Assistance	1,948,799		1,948,799
Other	<u>122,403</u>	<u> </u>	<u>122,403</u>
Total Operating Expenses	<u>4,537,156</u>	<u> </u>	<u>4,537,156</u>
Operating income	1,422,484	508,018	1,930,502
Retained earnings, beginning of year	<u>2,007,595</u>	<u>291,351</u>	<u>2,298,946</u>
Retained earnings, end of year	<u><u>\$ 3,430,079</u></u>	<u><u>\$ 799,369</u></u>	<u><u>\$ 4,229,448</u></u>

The following can be shown as supplemental information to provide additional information on the details of Set-Aside expenses:

**Sample State
Drinking Water State Revolving Fund
Schedule of Set-Aside Expenses
For the Year Ended June 30, 2XXX**

	<u>Administrative</u>	<u>State Program Management</u>	<u>Technical Assistance</u>	<u>Local Assistance</u>	<u>Total</u>
Salaries and benefits	\$ 215,975	\$ 771,923	\$ 176,080	\$ 494,540	\$ 1,658,518
Equipment				71,114	71,114
Contracts	395,147	247,795	63,488	457,085	1,163,515
Travel	5,749	17,359	5,740	16,125	44,973
Other expenses	<u>117,536</u>	<u>325,281</u>	<u>235,657</u>	<u>920,562</u>	<u>1,599,036</u>
Totals	<u>\$ 734,407</u>	<u>\$ 1,362,358</u>	<u>\$ 480,965</u>	<u>\$ 1,959,426</u>	<u>\$ 4,537,156</u>