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# Betty Montgomery Auditor of State

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## Bulletin 2005-002

**Date Issued:** April 13, 2005

**TO:** County Auditors  
City Finance Directors and Auditors  
School District Treasurers  
ESC Treasurers  
Community School Finance Officers  
Township Trustees and Clerks  
Township Administrators  
Village Clerks, Clerk-Treasurers, and Finance Directors  
Village Administrators  
Library Clerks, Treasurers, and Directors  
Special Districts  
Independent Public Accountants

**FROM:** Betty Montgomery  
Auditor of State of Ohio

**SUBJECT:** Recent AICPA Interpretation

### Introduction

By now many of you are aware that the American Institute of Certified Public Accountants (AICPA) has, as of March of this year, issued an interpretation of certain professional auditing standards. It will affect all of you in some way. Regrettably, the Auditor of State's Office (AOS) was given little notice and no implementing time to permit us to notify you and educate you to this new interpretation. Although we sought such time, we were not able to persuade the AICPA.

### The Summary

The simple result of this new interpretation is as follows:

1. IF YOU ARE REQUIRED BY LAW/RULE TO FOLLOW GAAP AND YOU DON'T, YOU WILL RECEIVE AN ADVERSE OPINION FROM THE AOS.

**NOTE:** IF, HOWEVER, YOU PUT YOUR CASH ACCOUNTING IN A GAAP-LIKE FORMAT, THE AOS CAN STILL GIVE YOU, IF YOU QUALIFY, AN UNQUALIFIED OPINION.

2. IF YOU ARE NOT REQUIRED BY LAW/RULE TO DO GAAP AND YOU FILE ON A CASH BASIS, THE AOS MUST GIVE YOU AN ADVERSE OPINION, BUT THE AOS WILL ALSO ISSUE AN ADDITIONAL OPINION – AN UNQUALIFIED OPINION - SHOULD YOU QUALIFY, BASED UPON YOUR CASH ACCOUNTING.

**NOTE:** IF YOU PREPARE A GAAP-LIKE FORMAT, YOU WILL RECEIVE ONE OPINION - AN UNQUALIFIED OPINION - SHOULD YOU QUALIFY.

### **The New Interpretation**

The AICPA is the national, professional association for all certified public accountants. One of the primary functions of the AICPA is to issue interpretations of certain professional auditing standards that require additional explanation. Since the AOS follows professional auditing standards in its audits of all public offices here in Ohio, the AOS must also comply with AICPA's interpretations of those standards.

On February 2, 2005, the AICPA issued an interpretation of one of its auditing standards (i.e., AU Section 623, *Special Reports*)<sup>1</sup> that affects those governments that prepare their financial statements using the cash or modified cash basis of accounting.<sup>2</sup> These entities report cash received and cash paid, rather than reporting their financial activity pursuant to generally accepted accounting principles (GAAP).<sup>3</sup>

In Ohio, many entities prepare their financial statements on a cash basis. According to this AICPA interpretation, these governments must adjust their financial statements to substantially conform with the display and now applicable disclosure requirements of GAAP in order to avoid an adverse audit opinion regarding GAAP. According to the interpretation, the cash basis financial statement presentation must “look like” a GAAP presentation (i.e., GASB Statement No. 34, *Basic Financial Statements – and Management’s Discussion and Analysis – for State and Local Governments*, once it became effective); otherwise, the AOS or contracted independent public accountant (IPA) firm is required to issue an adverse opinion. An adverse opinion means the auditor is telling readers that they cannot rely on the amounts, footnotes, or presentations in the financial statement as conforming with GAAP requirements.

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<sup>1</sup> A copy of the interpretation can be found on the web at <http://www.aicpa.org/members/div/auditstd/announce/index.htm>

<sup>2</sup> The only common modification to cash of which we are aware is including long-term investments as assets (such as certain governmental securities). Subsequent references to “cash basis” in this bulletin would also apply to this modification to the cash basis.

<sup>3</sup> This Bulletin does not apply to governments that prepare GAAP basis financial statements.

## Non-GAAP Mandated Governments

For entities that are not legally required to prepare their financial statement in accordance with GAAP and elect not to present “look alike” statements [such entities in Ohio include libraries, townships, villages, and special districts], the AOS will render a second opinion at the same time it issues its adverse opinion. In other words, when the cash statements do not resemble a GAAP presentation, the auditor will also issue a second opinion based on the statements as they were prepared. This second opinion can be an unqualified opinion, if the audit justifies such an opinion. Therefore, local governments would receive two opinions as part of their audit report if their cash statements do not look like GAAP statements (i.e., GASB 34).

For example, if one of these local governments prepares a cash basis financial statement that according to audit testing is presented fairly, the audit report would include 1) an adverse opinion for failing to present statements that resemble GAAP statements and 2) an unqualified opinion. See Example 1 in the **Appendix** for an example of this dual opinion, which is also available on the AOS website at [www.auditor.state.oh.us](http://www.auditor.state.oh.us).

To be clear, the AOS is not requiring libraries, townships, villages, or special districts to prepare financial statements using GAAP or cash basis statements that “look like” GAAP. Rather, by following professional auditing standards, the recent interpretation requires auditors (whether the AOS or contracted IPA firm) to issue a dual opinion on any government’s cash-basis financial statement that does not largely resemble a GAAP statement.

The annual reporting forms provided by the AOS and the annual reports currently generated by the Uniform Accounting Network do not meet the requirements of the new interpretation. We did not modify them since we did not wish to mandate the changes necessary to meet the interpretation’s display and disclosure requirements. However, governments that continue to use these forms as their audited statements will receive the dual opinion.

## GAAP-Mandated Governments that Prepare Cash Statements

The Ohio Administrative Code requires all counties, cities, school districts, educational service centers, and community schools to file their financial statements pursuant to GAAP (OAC 117-2-03). To reiterate, for governments to file in accordance with GAAP, they must follow the GASB 34 financial reporting model, which imposes significant changes from traditional cash statements.

If a GAAP-mandated government prepares for audit a cash basis financial statement that does not conform substantially to the display and disclosure requirements of GASB 34, it is not acceptable under current professional accounting and auditing standards for general-use financial statements. Consequently, the government would receive an adverse opinion and will not receive the second opinion on its cash-basis statements, since these entities are legally required to present financial statements pursuant to GAAP. Furthermore, professional auditing standards require that if an adverse opinion is rendered on a government’s financial statements, the auditor is required to disclaim an opinion on any accompanying supplementary information, such as the federal awards expenditure schedule. This disclaimer could result in adverse consequences on federal funding.

If a GAAP-mandated government follows the interpretation by preparing statements that *substantially conform with* the display and disclosure requirements of GASB 34, the AOS will issue an **Emphasis of a Matter Paragraph**, indicating the departures from the required GAAP reporting as well as any other opinion modifications required (see Example 2 in the **Appendix** for an example of an unqualified opinion that includes an **Emphasis of a Matter Paragraph**). However, this “emphasis of a matter” will not require an adverse opinion.

Furthermore, due to the recent AICPA interpretation, this Bulletin nullifies the implementation periods outlined in AOS Technical Bulletin 2003-006, which provide additional time for GAAP-mandated entities to substantially comply with GASB 34 requirements. Thus, if a GAAP-mandated entity’s financial statement is not prepared for audit in accordance with GASB 34 or if its cash statements do not conform with GASB 34 display and disclosure requirements, the entity will receive an adverse opinion beginning with financial statements for 2004. See Example 3 in the **Appendix** for the example adverse opinion, which is also available on the AOS website at [www.auditor.state.oh.us](http://www.auditor.state.oh.us).

### **Effective Date**

This interpretation, which was published in the March 2005 issue of the AICPA’s *Journal of Accountancy*, is intended to be effective upon publication. However, it was necessary to adequately train AOS staff to conduct audits in accordance with the provisions of the interpretation. Given these facts, the interpretation will be effective for audits whose opinions are dated April 1, 2005, and thereafter. (Opinion dates are determined by when field work has been completed on an audit.)

We are aware that the timing of the interpretation will create two types of audits for 2004: those where the field work was completed prior to April 1, 2005, and which are not affected by the interpretation; and those completed after April 1, 2005, which must conform to the interpretation’s requirements. We discussed this inconsistency with the AICPA and the possibility of extending the implementation date to avoid having to apply the requirements of the interpretation to any of the audits for 2004; however, our proposed approach was ultimately rejected.

As permitted by statute, many audits cover a two-year period. If the audit period includes fiscal years ending in 2003 and 2004, two reports will be issued. The report for 2003 will include the auditors’ reports, financial statements, and disclosures related to 2003. This Bulletin does not apply to 2003 reports. The report for 2004 will be subject to this Bulletin and will include the auditors’ reports, financial statements, and disclosures related to 2004.

### **Creating Cash Statements that Resemble GAAP**

If affected governments wish to prepare cash statements that conform with the display and disclosure requirements of GASB 34, several changes will need to be made from the way such statements were prepared in the past. While it is not possible in a short technical bulletin to describe all of the measures necessary to create these statements, below are some general procedures that should be followed. [Readers of this Bulletin are encouraged to simultaneously review the sample “look alike” statements, available on the AOS website at

[www.auditor.state.oh.us](http://www.auditor.state.oh.us).] Governments may also wish to obtain the AICPA’s Practice Aid Series, *Applying OCBOA in State and Local Governmental Financial Statements*, which includes extensive guidance and examples of acceptable statements.<sup>4</sup>

GASB 34 requires presenting two sets of financial statements, one set for the entity as a whole and one set still based on fund reporting. The entity-wide presentation is designed to show the government’s financial activities consolidated into one to three categories, which separately present governmental activities, business-type activities, and discrete component units, as applicable.

Preparing the entity-wide statements requires the following:

- The government should select the basis of accounting to be used for the “look alike” statements. For strictly cash-basis entities, the assets would be cash and cash equivalents and the net assets would be broken down into two categories: restricted and unrestricted. Entities wishing to add other assets, such as investments, would be considered to be using a “modified” cash basis of accounting.
- The government should consolidate its governmental funds into governmental activities - those that are largely funded through taxes, such as police and fire protection. Similarly, the government should consolidate its enterprise funds into business-type activities - those which are funded through user charges, such as sewer services. The government will have to use this information to create two entity-wide statements: a *Statement of Net Assets* and a *Statement of Activities*.
- Compared to non-GAAP statements, the *Statement of Activities* is a new, additional operating [“income”] statement. With the *Statement of Activities*, users of the financial statement can view the government’s level of revenue and expenses during the year by activity, ultimately arriving at a change in net assets (i.e., cash) for the year.
- Governments with component units must include information regarding component units in the entity-wide statements. Refer to GASB Statement No. 14 (codification Section 2100) for the definition of component units.

The second set of financial statements focuses on individual funds and requires the following:

- The government should prepare separate fund statements covering the following fund categories:<sup>5</sup>
  - Governmental funds – These funds account for the government’s “government activities” and include the general fund, the special revenue funds, the debt service funds, the capital projects funds, and the permanent funds.

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<sup>4</sup> To order a copy either visit AICPA’s Online Store at <http://www.aicpa.org/index.htm> or call 1-888-777-7077.

<sup>5</sup> Funds will have to be reclassified based on new fund type definitions set forth in GASB 34.

- Proprietary funds – These funds account for the government’s activities which are supported, at least in part, by user fees or charges. These funds include enterprise and internal service funds.<sup>6</sup>
  - Fiduciary funds – These funds account for situations where the government holds or manages financial resources in an agent or fiduciary capacity. These funds include the private purpose trust funds, the pension trust funds, the investment trust funds, and the agency funds.<sup>7</sup>
- Internal service funds and fiduciary funds will continue to be consolidated and presented by fund type. Governmental and enterprise fund statements will present separate columns for each “major fund.”
  - Major funds are those funds that exceed certain percentage requirements of total revenues, expenditures (i.e., expenses or disbursements), or assets.<sup>8</sup> In all instances, the general operating fund – usually the government’s general fund – is treated as a major fund. Additionally, the government may choose to designate funds that do not meet the minimum percentage requirement as major funds. Non-major funds will be added together and presented in one column.
  - For the general fund and each major special revenue fund, the government must include *Budgetary Comparison Statements*. Each of these statements must include original as well as final budgeted amounts to illustrate compliance with budgetary regulations.
  - The notes to the statements should include disclosures necessary for the basis of accounting used.
  - The government will need to write a *Management’s Discussion and Analysis*, which is an unaudited document that describes management’s analysis of the period’s financial operations, using narratives and tables. *Management’s Discussion and Analysis* samples are available on the AOS website at [www.auditor.state.oh.us](http://www.auditor.state.oh.us).

To reiterate, the procedures listed above are only intended to summarize the major procedures governments must follow to create cash statements that conform to GAAP display requirements.

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<sup>6</sup> These funds account for the financing of services provided by one department to other departments with the same government on a cost-reimbursement basis.

<sup>7</sup> Information on agency funds’ receipts and disbursements should be presented as supplementary information.

<sup>8</sup> The major fund threshold is generally 10% of the total governmental or enterprise funds’ revenues, expenditure/expenses, or assets. However, a complete description of these requirements exceeds the overview nature of this Bulletin. Financial statement preparers should refer to the Codification of GASB Standards.

## Available Assistance

Due to the highly technical nature of the AICPA interpretation and since many affected governments have already prepared and submitted their financial statements covering 2004, the AOS is prepared to offer its assistance. More specifically, the AOS will assist those governments preparing cash basis statements whose audit opinion dates fall after April 1, 2005 (provided the AOS performs their audit), if they choose to adjust their statements to conform to the GAAP display and disclosure requirements and avoid the adverse opinion. Therefore, these governments can request AOS assistance in adjusting their financial statements for an additional charge.<sup>9</sup> Alternatively, affected governments may choose to have their financial statements audited as they were submitted and receive the dual opinion described above.

If an IPA firm performs the audit, these governments may engage the IPA firm for assistance, or engage any other qualified firm or individual, if they choose to adjust their statements to conform with the GAAP display requirements and avoid the adverse opinion. The AOS does not need to approve these engagements or be included as a party to related contracts.

To further assist you in preparing statements that conform to the GAAP display and disclosure requirements, we have prepared financial statement templates for villages, townships, schools, counties, and cities. Other entity types can modify these statements to meet their needs. The financial statement templates are available on our website at [www.auditor.state.oh.us](http://www.auditor.state.oh.us).

We sincerely regret not being able to give you more notice. If you have any questions or wish to discuss this issue further, please contact David Varda, Chief Deputy Auditor, at (800) 282-0370.



Betty Montgomery  
Ohio Auditor of State

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<sup>9</sup> Our assistance is subject to the 2003 *Government Auditing Standards* independence standards amendment. In summary, these guidelines require the government to accept ultimate responsibility for the statements and disclosures, and to assign a knowledgeable management-level individual to review any work we prepare on a government's behalf and make decisions involving management functions.

## Appendix

### Cash (AOS Regulatory Basis) & Other Comprehensive Basis of Accounting (OCBOA) Opinion examples

- Example 1: Dual opinion applicable to governments **not** required to follow GAAP that do not amend their reporting to conform to OCBOA (i.e., GAAP “look alike”) requirements.
- Example 2: Unqualified opinion applicable to governments that amend their reporting to conform to OCBOA requirements. Opinion includes an **Emphasis of a Matter Paragraph**.
- Example 3: Adverse opinion applicable to governments **required** to follow GAAP that do not amend their reporting to conform to OCBOA requirements.



**Example 1: Dual (“Adverse” / Unqualified) Opinion on Financial Statements Prepared in Accordance with the Auditor of State’s (i.e., non OCBOA) Accounting Basis <sup>10</sup>**

**INDEPENDENT ACCOUNTANTS’ REPORT**

XYZ Township  
To the Trustees of XYZ Township:

We have audited the accompanying financial statements of XYZ Township, ABC County, (the Government) as of and for the year ended December 31, 2004. These financial statements are the responsibility of the Government’s management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

As described more fully in Note 1, the government has prepared these financial statements using accounting practices the Auditor of State prescribes or permits. These practices differ from accounting principles generally accepted in the United States of America. Although we cannot reasonably determine the effects on the financial statements of the variances between these regulatory accounting practices and accounting principles generally accepted in the United States of America, we presume they are material.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of the Government as of December 31, 2004, or its changes in financial position for the year then ended.

Also, in our opinion, the financial statements referred to above present fairly, in all material respects, the combined fund cash balances and reserves for encumbrances of XYZ Township, ABC County, as of December 31, 2004 and its combined cash receipts and disbursements for the year then ended on the basis of accounting described in Note 1.

In accordance with *Government Auditing Standards*, we have also issued our report dated April 15, 2005, on our consideration of the Government’s internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts

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<sup>10</sup> As the Bulletin states, we cannot use this opinion for governments required to follow GAAP. Example 3 will apply to these governments.

and grant agreements and other matters. That report describes the scope of our testing of internal control over financial reporting and compliance and the results of that testing. It does not opine on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with Government Auditing Standards. You should read it in conjunction with this report in assessing the results of our audit.

**Betty Montgomery**  
Auditor of State

April 15, 2005

**Example 2: Unqualified Opinion on Cash Basis (OCBOA) Statements  
(i.e., GASB 34 Display Format)**

**INDEPENDENT ACCOUNTANTS' REPORT**

XYZ Township

To the Trustees of XYZ Township:

We have audited the accompanying financial statements of the governmental activities, the business-type activities, the discretely presented component unit, each major fund, and the aggregate remaining fund information of XYZ Township, ABC County, Ohio (the Government), as of and for the year ended December 31, 2004, which collectively comprise the Government's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the Government's management. Our responsibility is to express opinions on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in the Comptroller General of the United States' *Government Auditing Standards*. Those standards require that we plan and perform the audit to reasonably assure 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 our audit provides a reasonable basis for our opinions.

**(The following paragraph applies only to governments required to follow GAAP.)**

Ohio Administrative Code § 117-2-03 (B) requires the Government to prepare its annual financial report in accordance with accounting principles generally accepted in the United States of America. However, as discussed in Note 1, the accompanying financial statements and notes follow the cash accounting basis. This is a comprehensive basis of accounting other than generally accepted accounting principles. The accompanying financial statements and notes omit assets, liabilities, fund equities, and disclosures that, while material, we cannot determine at this time.

**(The following paragraph replaces the preceding paragraph for governments not required to follow GAAP.)**

As discussed in Note 1, the accompanying financial statements and notes follow the cash accounting basis. This is a comprehensive accounting basis other than accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective cash basis financial position of the governmental activities, the business-type activities, the discretely presented component unit, each major fund, and the aggregate remaining fund information of XYZ Township, ABC County, Ohio, as of December 31, 2004, and the respective changes in cash basis financial position and the respective budgetary

comparison for the General and XXX Fund thereof for the year then ended in conformity with the accounting basis Note 1 describes.

In accordance with *Government Auditing Standards*, we have also issued our report dated April 15, 2005, on our consideration of the Government's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements and other matters. That report describes the scope of our testing of internal control over financial reporting and compliance and the results of that testing. It does not opine on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards*. You should read it in conjunction with this report in assessing the results of our audit.

Management's discussion and analysis is not a required part of the basic financial statements but is supplementary information the Governmental Accounting Standards Board requires. We have applied certain limited procedures, consisting principally of inquiries of management regarding the methods of measuring and presenting the required supplementary information. However, we did not audit the information and express no opinion on it.

**Betty Montgomery**  
Auditor of State

April 15, 2005

**Example 3: Adverse Opinion for Governments Required to Follow GAAP,  
But that Instead Use the Auditor of State's (i.e. non OCBOA) Accounting Basis**

**INDEPENDENT ACCOUNTANTS' REPORT**

ZZZ City  
ABC County  
To the Council Members of ZZZ City:

We have audited the accompanying financial statements of ZZZ City, ABC County, (the Government) as of and for the year ended December 31, 2004. These financial statements are the responsibility of the Government's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to reasonably assure 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.

Ohio Administrative Code Section 117-2-03 (B) requires the Government to prepare its annual financial report in accordance with accounting principles generally accepted in the United States of America. However, as discussed in Note 1, the accompanying financial statements and notes have been prepared on a basis of accounting not in accordance with these generally accepted accounting principles. The accompanying financial statements and notes omit entity-wide statements, and assets, liabilities, fund equities, and disclosures that, while material, we cannot determine at this time.

In our opinion, the accompanying financial statements do not present fairly the financial position, results of operations, and cash flows, where applicable, of XX City as of and for the year ended December 31, 2004 in accordance with accounting principles generally accepted in the United States of America.

The Government has not presented Management's Discussion and Analysis, which accounting principles generally accepted in the United States of America has determined is necessary to supplement, although not required to be part of, the financial statements.

In accordance with *Government Auditing Standards*, we have also issued our report dated April 15, 2005, on our consideration of the Government's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements and other matters. That report describes the scope of our testing of internal control over financial reporting and compliance and the results of that testing. It does not opine on the internal control over financial reporting or on compliance. That report is an integral part

of an audit performed in accordance with Government Auditing Standards. You should read it in conjunction with this report in assessing the results of our audit.

We conducted our audit to opine on the Government's basic financial statements. The Federal Awards Expenditure Schedule presents additional information and is required by U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. It is not a required part of the financial statements. We subjected this schedule to the auditing procedures applied in our audit of the Government's financial statements. For reasons stated in the third paragraph, the basic financial statements do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of the Government, as of December 31, 2004, or the changes in financial position or its cash flows for the year then ended. Therefore we are unable to express, and we do not express, an opinion on the Federal Awards Expenditure Schedule.

**Betty Montgomery**  
Auditor of State

April 15, 2005

