



State of North Carolina

Department of State Treasurer

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*State and Local Government Finance Division
and the Local Government Commission*

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To: Finance Officers of Counties, Municipalities, Boards of Education, Public Authorities, and Certified Public Accountants

From: T. Vance Holloman, Director
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Subject: Determining Materiality for Financial Statements Prepared in Accordance with GASB Statement No. 34

The Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments* (Statement 34) makes dramatic changes to the basic financial statements of local governments. New guidance for the purpose of planning, performing, evaluating the results of, and reporting on the financial statements prepared in accordance with Statement 34 is forthcoming from the American Institute of Certified Public Accounts (AICPA) in the new edition of the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* (the Audit Guide) due out at the end of the month. The AICPA has recently released an audit risk alert entitled *State and Local Government Developments-2002* (Audit Risk Alert) that describes the changes anticipated in the Audit Guide. The Audit Risk Alert was based on a draft of the Audit Guide that is still subject to change.

Opinion Units

Auditors should use their professional judgment in applying materiality. Materiality should be influenced by the auditor's perception of the needs of a reasonable person who will rely on the financial statements. Under the new model, materiality is determined separately for each opinion unit, a new term and concept originating in the Audit Guide. The opinion units are:

- Governmental activities
- Business-type activities
- Aggregate discretely presented component units (Aggregated all as a single unit)
- Each major governmental fund
- Each major enterprise fund
- Aggregate of all remaining fund information, (nonmajor governmental funds, nonmajor enterprise funds, internal service fund types, and fiduciary fund types, all aggregated as a single unit)

The reconciliations of fund and government-wide financial statements required by Statement 34 are linked to government-wide statements and should be considered in conjunction with those statements when assessing materiality. If the aggregate remaining fund information and/or the aggregate discretely presented component units are not material to the primary government, the opinion units may be combined to a single opinion unit. That opinion unit would be referred to as “the aggregate discretely presented component units and remaining fund information opinion unit.” Even if this combined opinion unit is not material to the primary government, it cannot be combined with any other opinion unit.

Quantitative factors, dollar amounts, and qualitative factors, nature of the transaction or balance, of the opinion unit should be considered when conducting the audit. The Audit Risk Alert states that an auditor should plan the audit to detect misstatements that individually or in total could be material to each opinion unit. The auditor should be alert to qualitative misstatements, but it is usually not possible to design tests to detect them. The qualitative significance of any misstatement should be considered.

Determining Materiality for Financial Reporting

GASB’s Guide to Implementation of GASB Statement 34 and Related Pronouncements, (Implementation Guide), discusses assessing materiality in preparing financial statements for reporting. Both quantitative factors and qualitative factors should be considered and materiality determinations should be consistent with the reporting requirements in Statement 34. Governmental activities, business-type activities, and each major fund are considered to be quantitative material. The focus of government and proprietary fund financial statements is on major funds (determined by quantitative measures). In determining materiality, there is no distinction between those funds that are required to be major and those that are voluntarily designated as major. In either case, the major fund would represent an opinion unit.

Statement 34 requires that nonmajor governmental funds, nonmajor enterprise funds and internal service funds each be aggregated and be presented in a single column in the fund financial statements. Although these single column presentations are similar to the reporting requirements of major funds, these funds are not focus of the fund statements, only the major funds are.

The Implementation Guide states that the determination of how these funds should be assessed for materiality should be based on professional judgment. Qualitative factors and quantitative factors should be considered. The Implementation Guide lists possible ways to determine quantitative materiality. It may be determined by comparing nonmajor governmental funds, nonmajor enterprise funds and internal service funds to all governmental funds and enterprise funds. It may be determined by comparing nonmajor governmental funds to total governmental funds, by comparing nonmajor enterprise funds and internal service funds to total proprietary funds, and by comparing fiduciary fund types to total fiduciary funds.

Major discretely presented component units are not equivalent to major funds. Materiality should be assessed considering the characteristics of major component unit information

presentation required in Statement 34 and based on the evaluation of both: a) The component unit's significance relative to the total discretely presented component units b) The nature and significance of the unit's relationship to the primary government. If there are no major component units, materiality should be assessed using professional judgment considering relevant qualitative factors and the relationship of the nonmajor component unit information to other appropriate information in the financial statements. For example, qualitative materiality of the component unit information might be determined based on its significance compared to governmental activities and business-type activities. Alternatively, it could be compared to major funds. The auditor should make a single quantitative materiality evaluation for the aggregate discretely presented component unit as is done with other opinion units.

Statement 34 indicates that the Management Discussion and Analysis (MD&A) is a component of required supplementary information (RSI). The Audit Risk Alert offers guidance on auditing opinion units that are part of the basic financial statements. RSI is not a part of the basic financial statements. The Audit Risk Alert indicates that the auditor does not express an opinion on RSI, but does make inquiries of management about how the method of measurement and presentation.

Effective Date

The Audit Risk Alert states that the Audit Guide will be effective for fiscal years ending after June 15, 2003, for which the unit has implemented GASB 34. Early implementation is encouraged for financial statements issued after the Audit Guide has been issued if the unit has implemented GASB 34. For the fiscal year ended June 30, 2002, our office will accept auditor's reports prepared under the updated audit guide or its predecessor. Opinions from the Audit Risk Alert have been included in the illustrative financial statements prepared in accordance with GASB 34 in the *Audit Manual for Governmental Auditors in North Carolina* (the Red Book), which is available on the Department's website (www.state.treasurer.nc.us). For subsequent fiscal years, the Audit Guide should be followed for all audits of units that have implemented GASB 34.

Any questions relating to this memo can be directed to Jim Burke at (919) 807-2383, 807-2398 (fax), or james.burke@treasurer.state.nc.us.