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General Accounting Office
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Accounting and Information
Management Division

B-275159

November 6, 1996

The Honorable James T. Walsh
Chairman, Subcommittee on the
District of Columbia
Committee on Appropriations
House of Representatives

Dear Mr. Chairman:

Your office requested that we determine the appropriateness of the accounting treatment of an error correction reflected in the District's fiscal year 1988 Comprehensive Annual Financial Report (CAFR). The error correction was made to properly account for certain loans made to first time home-buyers by the District during fiscal years 1979 through 1987.

We reviewed the information provided by your office, the District's fiscal years 1987 and 1988 CAFRs, the related accounting entries to record and correct the error, and relevant authoritative accounting pronouncements. We also discussed the matter with the District's Chief Financial Officer (CFO), other District officials, and KPMG Peat Marwick (KPMG), the District's lead auditor of record for the fiscal year 1988 CAFR.

In fiscal year 1988, the District recognized that it had not properly recorded the issuance of mortgage loans in its accounting records. The District determined that \$16,746,000 of mortgage loans disbursed in fiscal years 1979 through 1987 were reflected in the financial statements for those years as expenditures but should have been reflected as mortgage receivables. Had the loans been recorded in the appropriate years as mortgage receivables instead of expenditures, the District's ending fiscal year 1987 fund balance would have been greater by \$16,746,000. To correct the error, in fiscal year 1988, the District established a mortgage receivables account of \$16,746,000 and decreased its fiscal year 1988 expenditures account by the same amount. This caused the reported Deficiency of Revenues and Other Sources Under Expenditures in Fiscal Year 1988 of \$14,279,000 to be \$16,746,000 less than it would have been had the correction not been made.

GAO/AIMD-97-15R Prior Period Adjustment

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The issue is whether this accounting treatment in fiscal year 1988 was appropriate.

Accounting Principles Board Opinion (APB) no. 20, paragraph 36, Accounting Changes, states that if an error in the financial statements of a prior period is discovered and corrected in a subsequent year, the error correction should be reported as a prior period adjustment. Further, Financial Accounting Standard (FAS) no. 16 and APB no. 9 provide that prior period adjustments are to be made by adjusting the beginning retained earnings balance.¹ The District, in correcting its accounting error, adjusted expenditures on the Statement of Revenue, Expenditures, and Changes in Fund Balance. These accounting standards, though, explicitly state that they do not have to be applied if the items are immaterial.

In commenting on a draft of this report, both the District's CFO and KPMG agreed with the facts and circumstances surrounding the error correction but stated that the amount involved was considered immaterial. In its response, KPMG stated that it discussed the need to record a prior period adjustment with a District official, if the amount was felt to be material. KPMG also stated that the effect of the error correction was to reduce fiscal year 1988 expenditures by \$16,746,000—less than 1 percent of expenditures—an amount that it considered immaterial compared to total District expenditures of over \$2.5 billion. Further, KPMG stated that the District disclosed² the effect of the error correction in its notes to the financial statements.

As defined in FAS no. 2, materiality represents the magnitude of an omission or misstatement of an item in a financial report that, in light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the inclusion or correction of the item. Statements on Auditing Standards no. 47, paragraph 6 states that the auditor's consideration of materiality is a matter of professional judgment and is influenced by the perception of the needs of a reasonable person who will rely on the financial statements. Thus, accounting and auditing standards require that judgment be applied in determining whether a

¹The terminology used in state and local government accounting for retained earnings is fund balance.

²The District disclosed that the effect of the error correction was to decrease expenditures by \$22.8 million. However, District officials stated that only \$16.7 million of the \$22.8 million related to loans charged to expenditures in prior years.

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matter is significant enough to warrant an adjustment to or disclosure in financial statements.

We did not participate in the fiscal year 1988 audit of the District's financial statements, and KPMG's working papers from the fiscal year 1988 audit are no longer available for review.³ Consequently, we are not aware of all the factors that would have been considered by the District officials and the auditor in deciding whether the error correction should be reported as a prior period adjustment. Accordingly, we did not evaluate the reasonableness of their decision. In any event, the effects of the error correction presentation do not impact the District's current financial statements nor the financial statements for any fiscal year after fiscal year 1988.

We conducted our work during September 1996 and October 1996 in accordance with generally accepted government auditing standards.

We are sending copies of our report to the Ranking Minority Member of your Subcommittee; Chairman and Ranking Member of the Senate Subcommittee on the District of Columbia, Committee on Appropriations; Chairman and Ranking Member of the House Subcommittee on the District of Columbia, Committee on Government Reform and Oversight; and Chairman and Ranking Minority Member of the Subcommittee on Oversight of Government Management and the District of Columbia, Senate Committee on Governmental Affairs. In addition, we are sending copies of our report to the District's CFO, its Inspector General, and KPMG.

If you need further information, please contact me at (202) 512-9510 or Hodge Herry, Assistant Director, at (202) 512-9469.

Sincerely yours,



Gregory M. Holloway
Director, Governmentwide Audits

(901746)

³According to a KPMG official, audit working papers are retained for a 6 year period after the audit and are subsequently destroyed.

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