

## § 1773.32

over financial reporting issued in conjunction with the auditor's report.

[61 FR 108, Jan. 3, 1996, as amended at 63 FR 38723, July 17, 1998]

### **§ 1773.32 Report on compliance and on internal control over financial reporting.**

As required by GAGAS, the CPA must prepare a written report on the tests performed for compliance with applicable laws, regulations, contracts, and grants, and on the borrower's internal control structure and on the assessment of control risk made as part of the financial statement audit. This report must be signed by the CPA and must include, as a minimum:

(a) The scope of the CPA's work to obtain an understanding of the borrower's internal control structure and in assessing the control risk;

(b) A description of the reportable conditions noted which include material weaknesses identified as a result of the CPA's work in understanding and assessing control risk;

(c) If no reportable instances of non-compliance and no reportable conditions were found, the CPA must issue a report as illustrated in appendix A, exhibit 2 (Electric), and appendix B, exhibit 4 (Telecommunications) of this part 1773;

(d) If material instances of non-compliance and reportable conditions are identified, the CPA must issue a report as illustrated in appendix A, exhibit 3 (Electric), and appendix B, exhibit 5 (Telecommunications) of this part 1773;

(e) Other nonmaterial instances of noncompliance should not be disclosed in the report on compliance and on internal control over financial reporting, but should be reported in a separate communication to the board of directors, preferably in writing. All such communications must be documented in the workpapers and submitted to RUS in compliance with § 1773.21.

(f) If the CPA has issued a separate letter detailing immaterial instances of noncompliance, the report on compliance and on internal control over financial reporting must be modified to include a statement such as:

We noted certain immaterial instances of noncompliance that we have reported to the

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management of (borrower's name) in a separate letter dated (month, day, year).

(g) If the CPA has issued a separate letter to management to communicate other matters involving the design and operation of the internal control over financial reporting, the report on compliance and on internal control over financial reporting must be modified to include a statement such as:

However, we noted other matters involving the internal control over financial reporting that we have reported to the management of (borrower's name) in a separate letter dated (month, day, year).

(h) The report must contain the status of known but uncorrected significant or material findings and recommendations from prior audits that affect the current audit objective.

[63 FR 38723, July 17, 1998]

### **§ 1773.33 Management letter.**

The CPA must prepare a management letter that includes, at a minimum, comments on:

(a) *Audit procedures.* State whether the audit has been performed in accordance with this part;

(b) *Special reports.* State whether any special reports, summaries of recommendations, or similar communications were furnished to the borrower's management during the course of the audit or during interim audit work, and provide a description of the information furnished;

(c) *Accounting and records.* Comment on the adequacy and effectiveness of the borrower's accounting procedures, discuss the general condition of the records, and outline any recommendations for improvement. Comment on the adequacy and fairness of the methods used in accumulating and recording labor, material, and overhead costs, and the distribution of these costs to construction, retirement, and maintenance or other expense accounts, and where appropriate, include:

(1) Whether subsidiary plant records agree with the controlling general ledger plant accounts;

(2) Whether construction clearing accounts are cleared promptly of costs of completed construction to the proper classified plant accounts and whether

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depreciation was accrued on such completed construction from the date the plant was placed in service;

(3) Whether retirements of plant are currently and systematically recorded and properly priced;

(4) Whether all costs associated with retirements of plant are properly accounted for in the accumulated provision for depreciation accounts and comment on any unusual charges or credits to such accounts; and

(5) Whether RUS approval was obtained for a sale requiring such approval, and whether receipts from sales of plant, material or scrap were not handled in conformance with RUS requirements.

(d) *Materials control.* Comment on the adequacy of the control over materials and supplies.

(e) *Compliance with RUS loan and security instrument provisions.* State whether the following provisions of RUS's loan and security instruments have been complied with:

(1) For electric borrowers, provisions relating to:

(i) The requirement for funds to be deposited in banks or other depositories designated in the loan documents or approved by RUS. For purposes of this part, funds shall be defined as cash proceeds from loans made or guaranteed by RUS in accordance with 7 CFR 1717.612.

(ii) The requirement for a borrower to obtain written approval of mortgagees to enter into any contract for the management, operation, or maintenance of the borrower's system if the contract covers all or substantially all (90 percent) of the electric system. For purposes of this part, the following contracts shall be deemed as requiring RUS approval:

(A) Management contracts in which the borrower has contracted to have another borrower or other entity manage its affairs;

(B) Management contracts in which the borrower has contracted to manage another borrower or other utility system;

(C) Operations and maintenance contracts in which the borrower has contracted to have another borrower or other entity operate and/or maintain all or substantially all (90 percent) of

the physical plant facilities of the borrower.

(D) Operations and maintenance contracts in which the borrower has contracted to operate and maintain the physical plant facilities of another borrower or other utility system; and

(iii) The requirement for a borrower to prepare and furnish mortgagees annual financial and statistical reports on the borrower's financial condition and operations. For borrowers with a December 31 year end, the CPA must state whether the information represented by the borrower as having been submitted to RUS in its most recent December 31 RUS Form 7 or Form 12 is in agreement with the borrower's audited records. For borrowers with a year end other than December 31, the CPA must state whether the information appears reasonable based upon the audit procedures performed. If the borrower represents that an amended report has been filed as of December 31, the comments must relate to the amended report.

(2) For telephone borrowers, provisions relating to:

(i) The requirement for a borrower to obtain written approval of the mortgagees to enter into any contract for the operation or maintenance of property and for the use of mortgaged property by others, or for services pertaining to toll traffic, operator assistance, or switching. For purposes of this part 1773, the following contracts shall be deemed as requiring RUS approval:

(A) Any contract, agreement or lease between the borrower and an affiliate other than as allowed under 7 CFR part 1744, subpart E;

(B) Any lease of a building or land; and

(C) Any other contract as defined in §1773.34 (e)(2)(i) except:

(1) Industry standard traffic settlement agreements involving inter-exchange and long distance carriers which, in form and substance, conform with contracts in general use in the telecommunications industry;

(2) Billing and collecting agreements;

(3) Toll pooling arrangements involving National Exchange Carrier Association and state associations;

(4) Directory services agreements; and

(5) Joint use agreements;

(ii) The requirement for funds to be deposited in banks or other depositories designated in the loan documents or approved by RUS. For purposes of this part 1773, funds shall be defined as cash on deposit in demand and time accounts, and certificates of deposit; and

(iii) The requirement for a borrower to prepare and furnish mortgagees annual financial and statistical reports on the borrower's financial condition and operations. For borrowers with a December 31 year end, the CPA must state whether the information represented by the borrower as having been submitted to RUS in its most recent December 31 RUS Form 479 is in agreement with the borrower's audited records. For borrowers with a year end other than December 31, the CPA must state whether the information appears reasonable based upon the audit procedures performed. If the borrower represents that an amended report has been filed as of December 31, the comments must relate to the amended report.

(iv) The requirement that a borrower maintain either a net plant to secured debt ratio or a funded reserve.

(A) For loans approved after June 10, 1991, and before October 7, 1997, if a borrower selected a loan maturity period in excess of the expected economic life of the facilities financed, the borrower must maintain a secured debt ratio of at least 1.2 or a funded reserve. If, during the audit period, the borrower has been issued refunding notes that match the remaining composite economic life of the facilities thus eliminating the requirement, the auditor should so state.

(1) If the net plant to secured debt ratio option was selected, this ratio must be achieved one year following the first advance of funds.

(2) If the funded reserve option was selected, the reserve must be of such amount that the balance of the reserve plus the value of the facilities less depreciation be at least equal to the remaining principal payments on the loan. Funding of the reserve must begin within one year of approval of re-

lease of funds and must continue regularly over the composite economic life of the facilities financed.

(B) For loans approved after October 7, 1997, if a borrower selected a loan maturity period in excess of the expected economic life of the facilities financed, the borrower must maintain a funded reserve in such amount that the balance of the reserve plus the value of the facilities less depreciation be at least equal to the remaining principal payments on the loan. Funding of the reserve must begin within one year of approval of release of funds and must continue regularly over the composite economic life of the facilities financed. If, during the audit period, the borrower has been issued refunding notes that match the remaining composite economic life of the facilities thus eliminating the requirement for maintaining the funded reserve requirement, the auditor should so state.

(f) *Related party transactions.* State whether all material related party transactions have been disclosed in the notes to the financial statements in accordance with SFAS No. 57, entitled "Related Party Disclosures". If the audit did not disclose any related party transactions considered to be material, either individually or in the aggregate, so state;

(g) *Depreciation rates.* For electric borrowers, comment when the depreciation rates used in computing monthly accruals are not in compliance with RUS requirements (See RUS Bulletin 183-1, Depreciation Rates and Procedures), which require the use of depreciation rates that are within the ranges established by RUS for each primary plant account, or with the requirements of the State regulatory body having jurisdiction over the borrower's depreciation rates; and

(h) *Deferred debits and deferred credits.* For electric borrowers, provide a detailed analysis of the totals reported as deferred debits and deferred credits, including, but not limited to, margin stabilization plans, revenue deferral plans, and expense deferrals. The CPA must state whether RUS has approved, in

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writing, each regulatory asset and liability.

[56 FR 63360, Dec. 3, 1991, as amended at 59 FR 659, Jan. 6, 1994; 61 FR 108, Jan. 3, 1996. Redesignated and amended at 63 FR 38723, July 17, 1998; 63 FR 40169, July 28, 1998]

### §§ 1773.34–1773.37 [Reserved]

### Subpart E—RUS Required Audit Procedures and Documentation

#### § 1773.38 Scope of engagement.

(a) RUS requires that the audit procedures set forth in §§1773.39 through 1773.45 be performed annually by the CPA during the audit of the RUS borrowers' financial statements, which audit procedures may be in addition to the conduct of a GAGAS audit.

(b) The CPA must exercise professional judgment in determining whether any auditing procedures in addition to those mandated by GAGAS or this part should be performed in order to afford a reasonable basis for rendering the auditor's report, report on compliance, report on compliance and on internal controls over financial reporting, and management letter.

#### § 1773.39 Utility plant and accumulated depreciation.

(a) *General.* The audit of these accounts must include tests of additions, replacements, retirements, and changes. Based upon the CPA's determination of materiality, an appropriate sample of transactions must be selected for testing. The CPA's workpapers must document that he/she:

(1) Examined direct labor and material transactions to determine whether the borrower's accounting records reflect a complete accumulation of costs;

(2) Examined indirect costs and overhead charges to determine if they conform to the Uniform System of Accounts;

(3) Reviewed the costs of completed construction and retirement projects to determine if they were cleared promptly from the work in progress accounts to the classified plant in service accounts and the related depreciation reserves;

(4) Examined direct purchases of special equipment and general plant;

(5) Determined the degree of accuracy and control of costing retirements, including tests of salvage and removal costs;

(6) Reviewed the borrower's work order procedures; and

(7) Reviewed depreciation rates for adequate support, compared them to RUS guidelines, and determined if they are in compliance.

(b) *Construction work in progress.* (1) The workpapers must include a summary of open work orders reconciled to the general ledger. The CPA must note on the summary any unusual or non-typical projects.

(2) Based upon the CPA's determination of materiality, an appropriate sample of work orders must be selected for testing. The CPA's workpapers must document that he/she:

(i) Reviewed equipment purchases charged to work orders, including payments and receiving reports;

(ii) Reviewed contracts showing the scope of the work, the nature of the contract, the contract amount, and scheduled payments and reviewed supporting documents to determine that all services contracted for were in fact rendered;

(iii) Reviewed time cards and pay rates for several employees who allocate their time to work orders;

(iv) Reviewed the nature of material and supplies issued to the project, traced amounts and quantities to supporting documents, and reviewed the reasonableness of clearing rates for assignment of stores expense to the work order;

(v) Reviewed the accuracy of the computation of overheads applied to the work order; and

(vi) Reviewed other costs charged to the work order for support and propriety.

(3) Based upon the CPA's determination of materiality, an appropriate sample of completed contracts must be selected for testing. The CPA's workpapers must document that he/she:

(i) Scheduled payments to contractors and traced to verify payments and supporting invoices;

(ii) Traced contract costs to final closeout documents, to the general