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MEMORANDUM #2017-08

TO: Local Government Finance Officials

FROM: Sharon Edmundson, Director, Fiscal Management Section

SUBJECT: Local Entities Responsibilities for the Financial Reports and Records

DATE: September 16, 2016

As audit season is upon us, we want to revisit some important issues regarding the annual audit.

Auditing standards, which all CPAs must follow, do not permit an auditor to audit his or her own work as it impairs the firm's independence. When an auditor drafts the financial statements of an entity, there may be confusion about how much work the auditor can do without impairing the independence that is required. A gray area exists - where is the line that the auditor cannot cross – what is the limit to his or her involvement in the preparation of the financial statements and the underlying records? How many adjusting journal entries are too many?

While there are no easy answers to these questions, the standards provide some helpful guidelines to advise auditors and their clients. The auditor cannot take the place of management in the decision-making process. That means that management has to decide which adjusting journal entries get recorded, not the auditor. It is important that auditors consider the independence issue before proceeding with any decisions that may be questionable. It is equally important that units of government understand that the auditor is not being difficult or uncooperative but simply trying to adhere to the standards that govern his or her work.

We understand that not all units have sufficient staff to write their own financial statements. Local entities need to understand that this does not alleviate their responsibility for the annual financial statements or for the underlying accounting records that support those statements. Regardless of who writes the financial statements, they are 100% the responsibility of the unit of government. The auditor is responsible for the opinions expressed in the report, but the remainder of the report belongs to the issuing unit of government.

How does this affect units that do not have adequate staff to prepare GAAP financial statements? How can they meet this requirement of accepting responsibility for the statements if there is no one on staff or the Board that is fully trained in governmental GAAP? One alternative that we are seeing more units take advantage of is the hiring of a third party accountant to work on the underlying records and to write the financial statements. These types of arrangements can vary from an annual engagement for the accountant to close the books and write the full set of GAAP financial statements, to a monthly engagement under which an accountant posts the monthly entries, reconciles the statements and ledgers, drafts monthly interim reports for the Board, and does the year-end close out and preparation of the GAAP financials.

There are multiple benefits to these engagements, the most obvious being that the financial statements are drafted separate and apart from the audit process which helps to ensure auditor independence. The unit may see a reduction in the audit fee, as the auditor can focus on auditing and not bookkeeping or statement writing. If the unit chooses to do so, it can contract for the accountant to not only reconcile the bank accounts and subsidiary ledgers, but also to provide interim financial reports for the Board,. This provides Board members current and accurate financial information on which to base their decisions and unit staff has less work to do at year-end to get ready for its audit. Mistakes and possibly fraud may be spotted in a more timely manner because the books are being kept current. It is almost always less expensive to contract for this service than to hire a full-time employee that is skilled and trained in governmental GAAP accounting. By keeping its books up to date, governments can focus more on financial management and less on the details of the bookkeeping. The SLGFD maintains a list on its website of accounting firms that provide this type of service. You can access it at https://www.nctreasurer.com/slg/lfm/audit_acct/Pages/Accounting-Services.aspx

We sometimes hear from auditors that local entities protest any findings the auditor discloses in the report. Entities must realize the auditor is bound by auditing standards to disclose instances of non-compliance. While no one likes to have errors in their work written up, it is the auditors' job to do just that. A finding does not automatically mean that the entity staff is not doing their jobs, or that management is negligent. A finding discloses where there is a weakness in operations and it should be used as a learning opportunity. Some findings are not going to be easily eliminated, such as a separation of duties finding in a small government. But there are steps entities can take to mitigate the finding, such as hiring a third party bookkeeper as was discussed earlier in this memo. Unit staff should review all findings with the auditor prior to the release of the report to make sure that information that is critical to the findings wasn't overlooked or inadvertently omitted.

One important concept everyone needs to understand is what an audit is not. There are many misconceptions surrounding what exactly an audit represents. A financial audit that results in a "clean" or unmodified opinion means that the auditor believes that the financial statements are materially correct. It does not mean the numbers are 100% correct. It does not mean the records are free from mistakes, nor does it mean there has been no fraud. In fact, the audit is not designed to find fraud. The audit is designed to determine if the statements materially represent the financial condition of the unit of government regardless of what that condition is.

Lastly, some local entities view the annual audit as something that has to be done to comply with the statutes, and see little to no value in the process. The annual audit provides management and elected leaders an unbiased review of the year's financial transactions and their effect on the fiscal health of the government. It provides guidance on where there are operational weaknesses; those weaknesses make it easier for mistakes or fraud to go unchecked. Finally, because the financial report is prepared on a GAAP basis, it is comparable not only to prior years' reports of your entity, but to other local governments as well. This allows for thoughtful analysis of financial trends, and benchmarking with other units of similar size, geographic location, or other traits.

In conclusion, the annual audit is an important piece of the fiscal operations and management of a unit of government. Auditors and clients need to understand their roles in the audit in order to make it a successful and meaningful process.