

# Auditing

## INTRODUCTION

Auditors, after an independent and objective examination of the financial statements of a school district, present a written report expressing their opinion as to whether or not those financial statements present fairly (in all material respects) the financial position and results of operations for the financial period. The major purpose of such an examination is to investigate and determine if the financial statements submitted for audit have been prepared in accordance with generally accepted accounting principles (GAAP), and it is accomplished by an outside, independent auditor through use of generally accepted auditing standards. Emphasis is placed upon the school district's system of internal control, which should be designed to serve several functions. These functions are to establish and maintain safeguards for conserving and preserving the school district's financial resources and property, to mitigate the potential for intentional or unintentional errors of omission or commission and to mitigate the potential for fraud.

## OUTCOMES

In this chapter, you will learn how to do the following:

1. Fairly report the financial condition of a school district.
2. Identify advantages of using independent audits.
3. Prepare specifications, recommendations and presentations of the audit report.

## AUDIT REPORTS

Financial accounting for elementary and secondary school districts is technical. Limited sources of revenue and restrictions placed upon the purposes for which money may be used make it as complicated as any area of financial and managerial accounting. The accountants for the school district, the internal auditors and the independent auditor have to be well trained. Financial accounting, reporting and auditing for elementary and secondary school districts are fields of specialization. Time and study are required in order to acquire the knowledge and the ability to apply principles, procedures and standards effectively in practice.

The independent audit's objective is an attestation of the auditor regarding the fairness and reliability of the financial statements. In the form of a written audit report, which accompanies the financial statements, the opinion of the auditor is addressed to the board of education. Under GASB 34 preparation requirements, the administration of the district is required to prepare a written report known as the management's discussion and analysis (MD&A).

*Financial Accounting for Local and State School Systems: 2009 Edition* (Allison et al., 2009, 84) identifies the following regarding MD&A:

The management's discussion and analysis (MD&A) is part of the required supplementary information (RSI); however, it precedes the financial statements. It should be based on currently known facts as of the date of the audit report and should

- provide a concise, unbiased and easily readable description of the government's financial activities; and
- help users understand the relationship of the results reported in the governmental activities in the government-wide financial statements and the results reported in the governmental funds financial statements (usually focused on the major funds).

The focus of the MD&A should be on the primary government. However, information on any discretely presented component units may be presented as well. GASB has stated that both the positive and negative aspects of the government's operations should be presented to inform the reader about whether the government is in better or worse financial condition than in the prior year. The focus should be on only significant or material items.

The MD&A is restricted to the following topics, although there is no limit to the information that may be presented about these topics:

- Information and discussion on the basic financial statements presented, their relationship to one another and the significant differences in the information they provide. The discussion should include the different methods of accounting used in the government-wide and fund financial statements.
- Condensed financial information comparing the current year and the prior year. The analysis should include specific economic factors that contributed to the change. Charts and graphs may be used to supplement information in the condensed statements but should not be used in place of it.
- Objective analysis of the governmental entity's financial condition as a whole. Analysis of the government's overall financial position and results of operations should address both governmental and business-type activities separately.
- An analysis of balances and transactions on a fund basis, addressing the reasons for significant changes in fund balances or fund net assets. The analysis should also include information on whether restrictions, commitments or other limitations significantly affect the availability of fund resources for future use.
- A discussion on significant variances among the entity's original budget, final budget and actual expenditures for the General Fund or its equivalent and the impact of these variances on the entity's future liquidity.
- A description of activity relating to the government's capital assets and long-term debt activity during the year. This discussion should include commitments made for capital expenditures, changes in credit ratings and debt limitations affecting the financing of planned facilities or services.
- A discussion of information about the modified approach used to report some or all of the infrastructure assets, if applicable.
- A description of currently known facts, decisions or conditions expected to have an impact on financial position and results of operation. The term *currently known* is limited to events or decisions that have occurred, been enacted, adopted, agreed on or contracted as of the date of the auditor's report. The discussion should address expected effects on both governmental and business-type activities.

Information that does not address the requirements above should not be included in the MD&A but instead may be reported as supplementary information or included in the letter of transmittal. The entity should ensure that information contained in the MD&A is not duplicated in the letter of transmittal. Differences between the MD&A and the letter of transmittal are outlined in exhibit 9 [see textbox 24.1]. . . .

If the reporting entity provides comparative financial statements by presenting basic financial statements and RSI for two years, a separate MD&A for each year is not required, but it must address both years presented in the comparative financial statements. MD&A should include comparative condensed financial information and related analysis for both years.

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**TEXTBOX 24.1.****Important Distinctions between the MD&A and the Letter of Transmittal***MD&A*

- Presented as part of the financial chapter in the comprehensive annual financial report (CAFR)
- Must present only topics required by GASB Statement 34
- Provides a summary and analysis of the government's overall financial position and operations
- Highly structured and requires information only on currently known facts, conditions or decisions

*Letter of Transmittal*

- Presented as part of the introductory chapter in the comprehensive annual financial report (CAFR)
  - Not limited to topics described in GASB standards
  - Provides an opportunity to discuss future plans
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**COMPONENT UNITS**

According to Allison and colleagues (2009, 84):

It is essential that governmental financial statements provide an overview of the reporting entity that is based on financial accountability, yet allow users to distinguish between the primary government and its component units. GASB Statement 14, *The Financial Reporting Entity* (issued in June 1991), established criteria for evaluating potential component units and provided guidance in the statement presentation of those entities that met the criteria. Component units are defined as legally separate organizations for which the primary government is financially accountable or for which the nature and significance of the relationship with the primary government are such that exclusion would cause the reporting entity's financial statements to be misleading or incomplete (Statement 14, Paragraph 20).

Financial accountability for a potential component unit is determined by either of the following:

- appointment of the voting majority of the potential component unit governing board by the primary government *and either*
  - the ability to impose its will on the potential component unit; *or*
  - a relationship of financial benefit or burden with the potential component unit.
- whether or not the potential component unit is fiscally dependent upon the primary government.

If a potential component unit does not meet either of the two tests above for financial accountability, an organization may still be included in the financial statements of the primary government based on the criterion that exclusion would result in a misleading or incomplete presentation of the financial reporting entity.

In May 2002, GASB issued Statement 39, *Determining Whether Certain Organizations Are Component Units*, which amended Statement 14 to establish the criteria for the inclusion of organizations on this basis. A legally separate, tax-exempt organization should be reported as a component unit if all of the following criteria are met:

- The economic resources of the separate organization are received or held for the benefit of the primary government, its component units, or its constituents.
- The primary government, or its component units, may access or is entitled to a majority of the economic resources of the separate organization.
- The economic resources of an individual organization that the primary government, or its component units, is entitled to or may access are significant to the primary government (Statement 39, Paragraph 5).

This standard continues the requirement for inclusion of organizations based on the GASB Statement 14, Paragraph 20 “misleading or incomplete” criterion, but emphasizes that “financial integration” may also be a component of all of the aforementioned criteria. Additional guidance on evidence of financial integration is also provided in GASB Statement 39.

Component units may be

- *blended*, as though they are part of the primary government [legally separate from the reporting entity, but intertwined with the reporting entity]; or
- *discretely presented* [presentation of financial data separate from the financial data of the primary government].

GASB Statement 34 does not amend the definition of component units or the general reporting requirements.

### ADVANTAGES OF INDEPENDENT AUDITS

Some advantages of independent audits are as follows:

- An outside, independent audit adds credibility to the financial statements.
- The audit tends to discourage fraud and embezzlement on the part of the school district’s financial managers and employees.
- Audited financial statements are required by outside creditors, potential bond holders and governmental agencies at the state and federal levels. They provide creditors a more confident basis for decisions about extending credit. They play an important part in state and federal securities laws.
- Independent audits frequently include recommendations for improving internal accounting and management controls and tend to minimize errors and irregularities in the accounting records.
- Audited financial statements provide insurance companies a more confident basis for settling claims for insured losses.
- Audited financial statements provide unions and the board of education an objective basis for contractual agreements.

Through the use of annual financial statements audited by outside and independent accountants, the board can make complete and timely financial information about the financial affairs of the school district available to the public. In this way, the board can create and maintain confidence in the financial administration of the school district. Examinations made only once every two, three or four years do not provide the value of timeliness of financial information.

### REQUEST FOR PROPOSALS

While there is no specific legal requirement to change auditors annually, many boards of education review auditors annually, even if they choose not to change firms. The task of selecting the independent auditors and defining the scope of the engagement should be reserved for the board or for an audit committee composed of board members.

The American Institute of Certified Public Accountants has issued many Statements on Auditing Standards (SAs), which deal with the performance of audits by public accountants. While these have direct bearing on the performance of the audit, their effect on the client is usually indirect. However, two are of particular note because they do directly affect the client. They are SAS 114, The Auditor’s Communication with those Charged with Governance, and SAS 115, Communicating Internal Control Related Matters Identified in an Audit.

The purpose of SAS 114 is to ensure that those charged with the governance (the school board) of an entity (school district) clearly understand what the auditors do relative to the audit and what the district is responsible for

relative to the financial statements. Auditors often provide substantial help pulling together and formatting financial statements, however these are the district's financial statements and the board and administration are responsible for their content. This also clarifies that the auditors should communicate any findings directly to the board.

SAS 114 requires that the auditor

- a. communicate clearly with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, and an overview of the scope and timing of the audit;
- b. obtain from those charged with governance information relevant to the audit; and
- c. provide those charged with governance with timely observations arising from the audit that are relevant to their responsibilities in overseeing the financial reporting process.

The purpose of SAS 115 is to ensure that if during the course of an examination of the financial statements of an entity the auditor finds a control deficiency that meets the definition of a significant deficiency or a material weakness, the auditor communicates that information to management and those charged with governance of the entity.

SAS 115 provides the following definitions:

Paragraph .05 A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis.

A deficiency in *design* exists when

- a control necessary to meet the control objective is missing; or
- an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met.

A deficiency in *operation* exists when

- a properly designed control does not operate as designed; or
- the person performing the control does not possess the necessary authority or competence to perform the control effectively.

Paragraph .06 A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Paragraph .07 A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Management and those charged with governance of an entity, however, are not required to correct the reported deficiencies.

SAS 115 clearly states the following:

Paragraph .20 The existence of significant deficiencies or material weaknesses may already be known to management and may represent a conscious decision by management or those charged with governance to accept the risk associated with the deficiencies because of cost or other considerations. Management is responsible for making decisions concerning costs to be incurred and related benefits. The auditor's responsibility to communicate significant deficiencies and material weaknesses exists regardless of management's decisions.

The board of education must ultimately determine that it is satisfied with the district's accounting and reporting practices, procedures and internal controls after due consideration of costs and risks. Once the board of education believes that an adequate system of accounting is in operation and the system of internal control is working effectively, the annual cost of audits by outside accountants can be agreed upon by using one of three common methods:

- Per diem basis
- Flat fee basis
- Maximum fee basis

In either the flat fee basis or maximum fee basis, a provision is generally included whereby an adjustment can be made in the contract in the event the scope of the engagement has to be extended to cover unforeseen circumstances that might develop. In those cases where special services have to be rendered in establishing an adequate accounting system, or where work that could or should have been done by business office personnel has to be done by the auditing firm, the cost will be greater.

Neither an audit nor ASBO International's Certificate of Excellence Program establishes that a school district is fiscally strong. An unqualified audit opinion on each fund used by the school district states that the financial statements present fairly, in all material respects, the financial position, the results of operation, the changes in fund balances and the changes in financial position. ASBO International's Certificate of Excellence Program recognizes that the comprehensive annual financial report is prepared in keeping with generally accepted accounting principles and generally accepted auditing standards. Whether or not a school district is financially strong is an interpretation that must be made by the reader of the financial statements.

There are a variety of publications that describe the content of a request for proposal (RFP). The Illinois State Board of Education's publication *Preparing for Local Education Agency Audits* provides the following general contents of an RFP and the auditor selection process. The RFP process usually entails the steps listed in the following sections.

#### **Determination of Need**

Depending upon the state, there may be a legal requirement for the school district to have an annual or some other periodic audit. Barring a legal requirement, the board of education should have a policy stating the need and timing of an independent audit.

#### **Request for Proposal**

The school district should provide certain information to prospective auditing firms to enable the firms to have a clear understanding of the school district's needs. By using a standardized format, the RFP provides the school district with a better understanding and comparison of services that proposed auditing firms will provide. Textbox 24.2 shows the usual contents of an RFP.

#### **Evaluation of Proposals/Selection of the Auditor**

Prior to reviewing the responses from the RFPs, the board should designate a committee to review the proposals received and submit to the board the following:

- A summary of proposals received.
- A recommendation of the audit firm to be awarded the contract.

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**TEXTBOX 24.2.**  
**Contents of a Request for Proposal (RFP)**

*Introduction*

The RFP should identify the following:

- Name of the school district requesting the proposal
- School district contact person, including title and address, to whom the accounting firm should address the proposal, and to whom inquiries should be made regarding the RFP
- Fiscal year(s) to be audited
- Date and time for all proposals to be submitted
- Number of copies of proposal needed
- Any special instructions as to how the proposal should be delivered or addressed to indicate the contents

*Description of the School District*

The school district information disclosed in the RFP should include the following:

- Number of students currently enrolled
- Number of school buildings and facilities currently being occupied by the district
- Current-year budgeted revenues and expenditures
- Current-year budgeted revenues and expenditures from federally assisted programs listed by individual federal programs
- Brief description of the accounting system, including computer/software capabilities used by the school district
- Number of personnel: certified staff, support staff and number of people employed in the business office
- Any other characteristics unique to the school district that the evaluator feels are important for the auditing firm to know in order to gain a basic understanding of the school district
- Relationship between the school district and school district treasurer

*Scope of the Examination*

This section of the RFP should identify the type of audit required and any special audit requirements, including type of funds maintained by the school district, so that the auditing firm will know what is to be expected if awarded the contract. This section should specify that the audit should be conducted by the auditing firm under

- generally accepted auditing standards promulgated by the American Institute of Certified Public Accountants; and
- requirements under the Single Audit Act or other state and federal regulations.

The school district should also disclose whether the audit and reports are to be based upon a cash, modified accrual or accrual basis, whether the auditor should express an opinion on the combining and individual fund financial statements and whether any additional services beyond the normal audit scope are required.

*(continued)*

**TEXTBOX 24.2.**  
**(Continued)**

*Reports Required*

This section should specifically identify the type and number of reports that are to be prepared in connection with the audit examination, such as the following:

- financial statements and supplementary information to be included in the annual report of the school district;
- preparation of any annual financial report needed to be filed with the appropriate state and/or federal office; and
- any other reports requested by the board of education.

*Timing Requirements*

The following information should be included to inform the auditor of expected dates so that the audit firm may be able to determine the timing of their audit work:

- The date the accounting records for the year-end audit will be available and when the accounting firm can begin work
- The date a final audit report should be submitted to the board of education and whether the school district desires to have a representative of the audit firm available for presentation to the board of education
- The date reports are required to be submitted to state or other governmental agencies as these may be different from the date the final audit report will be presented to the board of education

*Proposal Content*

In order to alleviate any confusion as to what the audit examination encompasses and who will be performing the audit work, the following requests should be considered for inclusion:

- A statement from the firm regarding the understanding of the work as explained above and a brief description of the audit approach to be used to achieve this objective
  - Qualifications of the public accounting firm, including but not limited to experience in school district accounting, training programs designed to keep their staff current in the industry, involvement in governmental organizations and the size and location of the firm
  - A copy of the firm's last peer review report
  - The approximate timing of completion of the audit to meet the required deadlines stated above
  - Fee information as to the general audit, as well as any additional costs related to state or federal programs; this section should also indicate the extent to which the firm expects assistance from school district personnel
  - Resumes of the individuals who will be assigned to the engagement, including their school district experience
  - Names, titles, addresses and telephone numbers/e-mail addresses of at least three school district clients who may be contacted for references
  - An example school district audit report
  - Indication of whether any individuals will be available for oral interviews
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The committee selected to review the auditor's proposals may include board members as well as business office personnel who will have direct contact with the selected audit firm. This recommendation should include a summary of the basis for their decision as compared to other responding firms.

The designated committee should establish their priorities for selection prior to commencing a review of the proposals. To provide additional transparency, the committee may want to assign a point value to each priority. After these priorities and values are established, each committee member should review the proposals received, summarize the main points and provide any additional comments regarding the proposals. The individual comments and recommendations should be compared to those of the other committee members. Based upon these comments and the established priorities, the committee should be able to submit to the board of education an appropriate recommendation. If there appears to be more than one qualified firm, the committee should consider interviewing the firms in order to make the appropriate recommendation and obtain any necessary clarifications.

When the proposals are being reviewed, special attention should be devoted to the following items:

- References indicated in the proposal should be checked. Inquiries should be made regarding the following: quality of the audits received, service during the audit as well as throughout the year, timeliness of the audit reports and integrity and experience of the assigned audit staff.
- Reference checks should include not only the firm, but the individuals.
- Qualifications of the firms should be reviewed to determine the technical competence of the individuals, experience in the school district industry, adequate manpower to complete the audit in a timely fashion and involvement of the firm with school district organizations.
- Resumes of the individuals should be reviewed to determine if the assigned individuals will have the necessary expertise.
- The indicated audit approaches should be reviewed as the basis for determining the quality of the audit expected to be conducted, and the costs should be reviewed for reasonableness in conjunction with the services that the district will obtain from the firm awarded the audit.

While costs should be a factor, the decision should not be based solely on fees. Proposals that indicate a greater level of service, including meetings with the board of education and continuing contact throughout the year, may be justification for higher fees. However, the above items should be ranked for each proposal received. After discussion among committee members, the appropriate recommendation should be made.

#### **Contract for Audit Services**

The U.S. Department of Education regulation 34 CFR Part 74, Subpart P (Audit Requirements for State and Local Governments) requires certain standards be followed when arranging for audit services:

- LEAs maintain a code of standards of conduct governing persons awarding and administering contracts using federal funds.
- Officers, employees or agents of the LEA be prohibited from solicitation or acceptance of anything of monetary value, including gratuities and favors from current or potential CPAs.
- The competition for the CPA services be open and free.
- Contracts be made only with responsible CPAs who possess the potential ability to perform the required audit successfully.
- Consideration be given to such matters as the CPAs' integrity, compliance with public policy, record of past performances and financial and technical resources.

Subpart P also requires that small audit firms and audit firms owned and controlled by socially and economically disadvantaged individuals (target firms) shall be given the maximum practicable opportunity to participate in contracts awarded to fulfill the Single Audit Act requirements. The following steps should be taken:

- Ensure that target firms are used to the fullest extent possible.
- Make information on forthcoming opportunities available and arrange time frames for the audit so as to encourage and facilitate participation by target firms.
- Encourage contracting with target firms that have traditionally audited LEAs and, in such cases where this is not possible, ensure that these firms are given consideration for audit subcontracting opportunities.
- Encourage contracting with a consortium of target firms when a contract is too large for an individual target firm.
- Use the services and assistance, as appropriate, of such organizations as the Small Business Administration in the solicitation and utilization of target firms.

### **ENGAGEMENT LETTER**

An engagement letter is a formal contract between the school district and its certified public accounting firm. The engagement letter confirms the acceptance of the appointment and documents the agreed-upon terms. The engagement letter should establish a mutual understanding between the school district and audit firm of the terms, nature and limitations of the engagement. The audit firm should clearly communicate their understanding of the school district's audit and reporting objectives and requirements. This often includes the scope of the audit, the form of reports and any additional responsibilities assumed. It can usually be accomplished by referring to appropriate audit guides, standards, laws or regulations.

Likewise, the engagement letter should stipulate the responsibilities accepted by the school district. Generally, government audit agreements are formal, written contracts that are legally enforceable and difficult to change once executed. Thus, the exact contents of the engagement letter should be carefully determined by the parties involved. Informal understandings or arrangements are not desirable and should be avoided if possible. Any future modifications to the original agreement should also be in writing.

### **FINANCIAL STATEMENTS**

The objective of financial accounting and reporting is to analyze and record financial transactions in a meaningful way. So many limitations are placed upon the way by which money for school districts can be raised, and so many strings are attached to the way it can be used for school purposes, that simplicity and meaningfulness are difficult to achieve.

It is true that all of the assets and financial resources of a school district could be combined into one fund if all sources of revenue were to be used for general operation and if no strings were attached to any of the money. When these circumstances do not exist, however, the separation of financial transactions into self-balancing groups of accounts, which compose various funds, has been found to be the best way of providing meaningful financial statements and effective financial management.

### **SUMMARY**

In preparing financial statements for the school district, the accountant must keep in mind that not only are the technical objectives of analyzing and recording financial transactions to be achieved, but most important is that meaningful statements and reports are to be prepared for use by the administrators, the board and the public.

When statements are presented to the public that convey a full disclosure of financial facts, it is possible to secure the support of the public for achieving desirable educational goals and objectives within the limits of financial resources available.

**ACTIVITIES**

1. Discuss some advantages to having outside and independent examinations of the school district's financial records.
2. Discuss advantages and disadvantages of maintaining continuing contractual relationships with outside auditor firms for more than one year.
3. Identify the purpose of the opinion section of the audit report.
4. Interview a school business official to determine the following for that district:
  - a. Procedures used to secure an outside, independent audit.
  - b. District procedure for duration of agreement and changing independent auditors.
  - c. Process used to compare proposals when selecting an independent auditor.
  - d. Explanation of any comments in the auditor's formal communication with management and the board of education from the last fiscal year audit.
  - e. Satisfaction of the school board with information provided by the audit.
  - f. Community opinion or reaction to the independent audit.
  - g. Copies of an engagement letter for auditing services.
5. Prepare a draft request for proposal (RFP) for an independent audit and identify a process that could be used to select an auditor.