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THE UNIVERSITY of TENNESSEE
MUNICIPAL TECHNICAL ADVISORY SERVICE

In cooperation with the Tennessee Municipal League

TECHNICAL bulletin

June 28, 2010

NEW AUDIT STANDARDS: WHAT DO THEY MEAN TO LOCAL GOVERNMENTS?

Kay Stegall, Finance and Accounting Consultant

INTRODUCTION

State law requires that municipalities be audited. The financial statement audit must be performed in accordance with generally accepted government auditing standards also known as the Yellow Book.* What this means is that auditors must follow statements on auditing standards (SAS) issued by the American Institute of Certified Public Accountants (AICPA) and additionally must comply with government auditing standards issued by the United States Government Accountability Office (GAO). The audit industry has come under scrutiny in recent years due to some major corporate frauds and failures. As a result the industry has strengthened auditing requirements related to internal controls and communications of audit deficiencies.

NEW DIRECTIVES FOR AUDITORS

Your auditors should be asking more questions about internal controls, checks and balances, the control environment, and policies and procedures. AICPA has issued several new auditing standards. SAS 109 *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* and SAS 115 *Communicating Internal Control Related Matters in an Audit* will have a direct impact on local governments.

SAS 109 requires that auditors gain a more thorough understanding of the government's environment, including internal control. This standard defines internal control as:

> "A process affected by those charged with governance, management, and other personnel designed to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations".

SAS 115 requires the auditors to redefine internal control deficiencies documented during the audit process. Municipalities can expect to have more audit findings in their reports than in prior years.

***About Government Auditing Standards**

Government Auditing Standards (the "Yellow Book") contains standards for audits of government organizations, programs, activities, and functions, and of government assistance received by contractors, nonprofit organizations, and other nongovernment organizations. These standards, often referred to as generally accepted government auditing standards (GAGAS), are to be followed by auditors and audit organizations when required by law, regulation, agreement, contract, or policy. These standards pertain to auditors' professional qualifications, the quality of audit effort, and the characteristics of professional and meaningful audit reports. The Tennessee Division of Municipal Audit requires auditors who contract to perform municipal audits in Tennessee to follow these standards.

This may not mean you are handling transactions any differently than you have in the past but the auditors may not have asked the detailed level of questions that are now required in order to document compliance with the new standards. Audit findings referred to as "reportable conditions" in the past are now called "significant deficiencies." The term "material weakness" remains the same. Local governments that have not adopted control procedures to ensure financial transactions are processed accurately and completely can expect to see "significant deficiencies" or "materials weaknesses" in their audit reports.

The standard also requires certain communications related to significant deficiencies and material weaknesses to be made in writing to management and those charged with governance. The person(s) who holds responsibility for strategic oversight for the direction of the entity and obligations for the accountability of the entity are considered "those charged with governance." In local governments that is usually the board of mayor and aldermen, council or commission. Management and elected officials should expect to see and hear more communications before, during and after the audit.

A few examples of control deficiencies found in government auditing guidance that might be the basis for an audit finding include:

- Lack of awareness and the importance of controls by top management (elected officials, mayor, city manager or administrator)
  - Failure to ensure that policies and procedures are adopted
- Ineffective oversight by those charged with governance
  - Failure to hire competent personnel in key management positions
- Control systems (check and balances) are not adopted or are not working properly
- Identification of fraud
- Failure by management to correct previously communicated deficiencies

LOCAL GOVERNMENT RESPONSIBILITIES

Control over the manner in which a government processes its financial transactions is the responsibility of management. This always includes the governing board, who generally has delegated this day-to day oversight to the recorder, city manager, finance officer or city administrator.

Basic control procedures related to municipal finances and compliance issues are prescribed by the Comptroller of the Treasury, Division of Municipal Audit, in the *Internal Control and Compliance Manual for Tennessee Municipalities* (City Manual). The City Manual is updated regularly and can be located on Municipal Audit's Web site (www.tn.gov/comptroller/ma/). Two valuable resources for municipalities to use in structuring their financial and compliance practices are the City Manual and a book titled *Government Accounting, Auditing and Financial Reporting* more commonly called the *Blue Book*, published by the Government Finance Officers Association (GFOA). The latest version of the *Blue Book* is the 2005 revision and comes with a Study Guide to assist users in understanding the fundamental concepts presented. Each city in Tennessee was mailed a copy of the *Blue Book* when it was published by the Division of Municipal Audit. Finance staff

of each city should use this publication as a reference book in recording and reporting financial transactions of the city.

If basic procedures for financial and compliance practices have not been implemented by your government then you will more than likely see those new findings as noted above. To improve controls municipal officials should begin implementing the procedures from the City Manual. Don't wait on the auditors. The City Manual should be used as the minimum standard. Municipal management should add other procedures to further strengthen the reliability of financial data as necessary. GFOA also has several "best practice" publications available that will be beneficial in determining controls to implement.

Chapter one of the City Manual states in part:

> *"Municipal officials should develop a policies and procedures manual that incorporates or references all the policies and procedures required in this Internal Control and Compliance Manual plus any additional policies and procedures that are specific to the municipality. The manual should include the assignment of authority and responsibility".*

It further details specific checks and balances municipal officials should implement such as reconciling property taxes receivable detail from the general ledger to the balance of unpaid taxes in the property tax roll. Another requirement is that utility billings, collections and receivable balances be reconciled from the utility billing system to the detailed general ledger. Other procedures include reconciling fines collected to ticket records and court dockets; periodically test petty cash balances and daily cash balancing. It also emphasizes the need to separate the duties of authorization, recordkeeping (posting), custodial (cash and materials handling) and the review of related records, to ensure one person does not have complete control of the process from beginning to end. The separation of duties and review by management decreases the risk of theft, loss, error, or manipulation occurring and not being detected by municipal officials in a timely manner.

Municipal officials have the responsibility to ensure that municipal resources are being utilized in the most effective ways possible. No one likes to deal with red tape or jump through hoops to get things done but in order to maximize efficiency, controls must be implemented. Think about it, is the city or town receiving all the fines and fees it is entitled to from county court cases? How does anyone know if no comparison is done to see what should be collected? Are those rising fuel costs only because the price of fuel has skyrocketed? How do you know gas is not disappearing if a system is not in place to monitor usage by various departments?

WHERE DOES MY GOVERNMENT STAND?

Municipalities can begin to assess their controls by asking questions.

- What are employees doing?
- What can go wrong?
- Is the city collecting all the revenue it is due?

This process should be started before the auditors arrive. A good way to begin is document the specific job duties of each employee involved in any part of the financial process. Once that is done those duties should be reviewed to ensure they are separated as much as possible.

Determine what type of monitoring is done to ensure that transactions are being processed accurately and completely. Management should review at a very minimum:

- monthly financial reports
- bank reconciliations
- utility adjustment reports
- accounts receivable reconciliations
- police ticket and court docket reconciliations
- property tax reconciliations

Refer to the City Manual to get ideas on how to start a self assessment or contact your MTAS consultant for assistance.

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