What Should Government Financial Managers Know About New Auditing Standards?

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Peer Reviewed

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ABSTRACT

Recent changes to Government Auditing Standards (Yellow Book) require independent auditors to focus more than ever on assessing the risk of material misstatement of a governmental entity's financial statements. The Yellow Book revisions also make independent auditors more responsible for identifying and communicating deficiencies in internal control over financial reporting during a governmental audit. The Office of Management and Budget extends the internal control revision to include compliance with major federal programs. These changes will likely increase audit fees, produce more audit findings, and require additional resources to meet the mandate for governments to become more responsible for internal controls. Finance officers, financial managers and individuals charged with oversight of governmental entities should understand how these changes will affect their organization.

In 2006, the Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (AICPA) issued several new Statements on Auditing Standards (SASs) pertaining to the audit of financial statements. The independent auditors of all entities, including governmental units, must now focus more than ever on assessing the risk of material misstatement. Audit planning and procedures must specifically address areas where material misstatements, whether due to error or fraud, are most likely to exist (SAS Nos. 104-111). Auditors are also more responsible for identifying and communicating deficiencies in internal control that surface during the audit of public and private sector financial statements (SAS No. 112). These ASB standards are now incorporated into Government Auditing Standards which are commonly referred to as The Yellow Book.

The implementation of these new standards should improve the effectiveness of financial statement audits but will require substantially more audit work.[1] This could be costly to government audit clients in both audit effort and fees. A 2007 survey of accounting firms that conduct government financial statement audits predicted an increase of 10 to 15 percent in audit fees due to additional risk assessment procedures which are required by SAS Nos. 104-111.[2] The North Carolina Department of State Treasury and the Wisconsin Department of Health and Family Services (among others) have also warned their constituencies that expanded audit work in internal control (SAS No. 112) would likely add to the costs to perform a financial statement audit.[3,4] Furthermore, the Local Government Commission (State of North Carolina) has warned that no extensions of time for audit completion are planned due to these new requirements.[5]

The threshold for reporting internal control deficiencies in government audits is also lower under the new standards. This means that independent audit reports are now likely to expose more deficiencies in internal controls over financial reporting. In an attempt to assess the potential impact of SAS No. 112, the State of Arizona applied the new standard to internal control findings from a prior year. Table 1 shows that the total number of internal control findings increased from 419 to 451. Furthermore, an extremely large number of findings were reclassified from oral comments with state officials to written reports of material weaknesses and other significant deficiencies.[6] The increase in internal control findings is primarily due to SAS No. 112 expanding the definition of what constitutes a control deficiency. Thus, it is not unreasonable to expect other governmental agencies to incur a similar increase in their audit findings.

TABLE 1

State of Arizona Pre & Post SAS No. 112 Analysis

	Pre SAS No. 112	Post SAS No. 112
Material weaknesses	3	32
Reportable conditions	11	156
Management letter comments	65	78
Oral comments	340	185
Total	419	451

The driving force for these new auditing standards was accounting and business failures in the private sector and the resulting passage of the Sarbanes-Oxley Act of 2002. However, the emphasis on risk-based auditing and the changes in evaluating internal control are required for both private and public sector audits. It is incumbent for finance officers, financial managers, and individuals charged with oversight of governmental entities to understand how SAS Nos. 104-112 will affect the audit of their financial statements. Governmental entities cannot assume that they are immune to the type of weaknesses that occur in the private sector. For example, even though fraud may normally be viewed as more prevalent within the private sector, governmental agencies are expected to perform fraud risk assessments in high-risk areas.The lack of an antifraud program will now normally result in an audit finding.[7]

The Move to Risk-Based Auditing

Statements on Auditing Standards Nos. 104-111, commonly referred to as the risk assessment suite (See Table 2 below.), became effective with years *beginning* on or after December 15, 2006.[8] For many governmental units, particularly those with fiscal years ending June 30, the 2007/2008 audit was their first under the new standards. Risk-based auditing requires independent auditors to formally conduct and document risk assessment procedures related to operations, the environment, and internal control. For each audit, auditors must now evaluate the control environment, management's process of managing risks, the accounting information system, specific control activities, and management's monitoring of internal controls over financial reporting. Governmental financial managers can expect extensive inquiries, more observation of operations, additional inspection of documents, an expanded overall analysis of financial information and a more thorough evaluation of the design and implementation of internal control by their auditors. This differs from past audit practices, particularly for smaller government audit clients, because no longer can an auditor assume that internal controls either do not exist or are not effective and then expand tests of account balances, transactions, and disclosures to compensate.

The new risk-based standards also require auditors to document (based on their judgment) the nature and potential magnitude of the risk of material misstatement within the financial statements, whether due to error or fraud. Auditors must also design and perform audit procedures that are linked to the high risk areas. This requires auditors to annually prepare audit programs that are unique to each client which precludes a common practice of using a set of "canned" audit procedures. These new audit practices will materially affect the nature and magnitude of work performed and audit fees likely will increase. However, the potential for an auditor to issue an unqualified or "clean" audit report on materially misstated financial statements should be reduced.

TABLE 2

The Risk Assessment Suite of Statements on Auditing Standards

#	Pronouncement
104	*Amendment to Statement on Auditing Standards No. 1,* A Codification of Auditing Standards and Procedures ("Due Professional Care in the Performance of Work")
105	*Amendment to Statement on Auditing Standards No. 95,* Generally Accepted Auditing Standards
106	*Audit Evidence*
107	*Audit Risk and Materiality in Conducting an Audit*
108	*Planning and Supervision*
109	*Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
110	*Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*
111	*Amendment to Statement on Auditing Standards No. 39,* Audit Sampling

Recent Developments in Reporting on Internal Control

Statement on Auditing Standard No. 112, *Communicating Internal Control Related Matters Identified in an Audit,* significantly affects the auditor's consideration of and reporting on internal control over financial reporting.[9] This standard, which became effective for years *ending* on or after December 15, 2006, is also of particular interest to governmental entities because OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations,* extends the auditor's responsibilities to internal control over compliance with major federal programs.[10]

SAS No. 112 requires the auditor to provide a written report to management that: communicates the purpose of a financial statement audit; states that an opinion on internal control effectiveness is not being expressed; defines significant deficiency and where relevant material weakness in internal control; and identifies audit findings considered to be significant deficiencies and material weaknesses in internal control over financial reporting. Prior to this standard, written communication of internal control related matters was optional. Findings were often discussed in person with the client and included in the management comment letter with recommendations for the improvement in design and effectiveness of internal control. Oral communication by itself is no longer sufficient to satisfy auditing standards when significant deficiencies and/or material weaknesses exist.

The State of North Carolina believes that the quality of communication between the auditor, management, and respective government boards will be improved under SAS No. 112.[11] The Committee on Audit of the Regents of the University of California also reports that SAS No. 112 has "created some challenges for coordination", but implementation last year "has led to better communication."[12]

The purpose of a financial statement audit is to express an opinion on whether or not the financial statements conform to generally accepted accounting principles in all material respects. SAS No. 112 does not require the auditor to perform procedures to identify internal control deficiencies or express an opinion on the design and effectiveness of internal control over financial reporting. However, the auditor must communicate to the government audit client if significant deficiencies or material weaknesses in internal control are detected during the course of a financial statement audit. This communication must be in writing and accompany the financial statement audit opinion. Governmental entities must also receive a separate written report on internal control over compliance with major federal programs that accompanies the auditor's opinion on compliance.

Internal control deficiencies are conditions that do not allow management or employees to prevent or detect misstatements of the financial statements, or noncompliance with federal programs, on a timely basis. Deficiencies may exist either in the design or in the operation of internal control. An example of a design deficiency in internal control over financial reporting is the lack of a policy requiring segregation of incompatible duties. A deficiency in operation exists when incompatible duties are performed by the same person and there are no compensating controls.

Once auditors identify internal control deficiencies, they must evaluate the potential magnitude of misstatement or noncompliance. A material weakness exists when there is more than a remote likelihood that a material misstatement or material noncompliance will not be prevented or detected by the internal control system before the end of the year. Ineffective oversight of financial reporting and compliance with government programs are strong indicators of material weaknesses. The discovery of a material misstatement or case of noncompliance that was not detected by the client, even though subsequently corrected by the client, is also an example of a material weakness. See Table 3 below for additional examples of material weaknesses.

TABLE 3

Strong Indicators of a Material Weakness

• Restatement of previously issued financial statements due to a material misstatement
• Auditor discovery of material weakness that was not detected by the client, even though subsequently corrected by the client
• Ineffective oversight over financial reporting
• An ineffective internal audit or risk assessment function (for large or complex entities) and/or an ineffective regulatory compliance function (for entities in highly regulated industries)
• Identification of management fraud (of any magnitude)
• Failure to assess effect of a previously communicated deficiency (either correct or conclude will not be corrected)

A significant deficiency exists when there is more than a remote likelihood that a financial misstatement or instance of noncompliance of more than an inconsequential amount (clearly immaterial) will not be prevented or detected in a timely manner. The absence of controls over the selection and application of accounting methods and the absence of an antifraud program are ordinarily at least a significant deficiency and must be included in a written report. Additional examples include deficient controls over non-routine and nonsystematic transactions and deficient controls over the year-end financial reporting process. A combination of significant deficiencies is also a strong indicator of a material weakness.

Control deficiencies that might lead to inconsequential (those not rising to the level of significant deficiencies) misstatements or noncompliance may either be communicated orally and/or in writing through the management comment letter. They will not appear in the written reports on internal control over financial reporting and compliance with major federal programs.[13]

Potential Issues

The move to risk-based auditing has significantly affected and will continue to influence government budgets. A recent national study of audit fees for eleven large city/county governments shows that audit fees in fiscal year 07/08 ranged from 3 percent to 20 percent higher than in the prior year. Much of the cost increases were attributable to new auditing requirements. The largest increase was in Denver, Colorado where audit fees jumped $200,000 (19.6 percent).[14] Smaller units of government also faced audit cost increases in the past year. In Livingston County, Michigan the fiscal year 07/08 audit fee increased from $68,625 to approximately $80,000 (16.6 percent increase) because of changes in auditing procedures required by the new audit standards.[15]

A major concern for government financial managers is that the full cost of implementing SAS Nos. 104-111 will not be known for some time. Jennifer Carney, a partner with Grant Thornton LLP predicts that it may be as late as 2009 before these new standards are fully integrated into the audit process.[16] The costs associated with this learning curve could be substantial. Government audit clients should search for ways to make the audit more cost effective.

One potential way to reduce audit time and fees is for clients to become more active in designing, documenting and improving their systems of internal control. This can be accomplished internally and/or by employing outsiders. The City of Homer, Alaska recently contracted with their independent auditor to review their systems of internal control for the purposes of improving controls and facilitating auditor compliance with the risk assessment standards.[17] Internal control is the responsibility of management and working to identify, document, and limit the risks of material misstatement of the financial statements could reduce audit findings and costs.

A benefit of management's active involvement in internal controls is that the client will be in a better position to assist the auditors as they attempt to understand the controls over financial reporting. This could lead to lower audit fees due to a more timely comprehension of the government entity and its environment. Auditor confidence in management's commitment to internal control also could result in a more efficient audit with lower audit fees.

Another potential issue is that there will be more proposed audit adjustments as a result of risk-based auditing. Auditors must consider individual misstatements as well as misstatements in the aggregate, including adjustments not recorded in prior years, when evaluating audit findings. The new standards require auditors to propose adjustments for all known misstatements unless the amount is considered trivial by the auditor. This means than management will be expected to justify why immaterial and material adjustments are not booked.

Audit clients can also expect auditors to target their audit procedures to account balances, transactions, and disclosures where the greatest risk of material misstatement exists. Management can expect different areas of audit emphasis as well as differences in sample sizes when compared with audits prior to SAS Nos. 104-111. Understanding the risks of material misstatements will help management to understand the nature and extent of the auditing procedures.

SAS No. 112 lowers the threshold for a reportable deficiency in internal control. Prior to this standard the auditor was responsible for reporting the *known* magnitude of control deficiencies existing within a governmental unit. Now the auditor must consider the *potential* magnitude of financial statement misstatement and noncompliance with federal programs. More audit findings will likely result from this new auditing standard. Auditees must also become aware that previous years' findings which were not reportable may now be reportable deficiencies. Furthermore, prior year findings that were communicated only orally may now be included in the written reports on internal control if there has been no remediation. The Local Government Commission (State of North Carolina) "expects that auditors of smaller units of governments will be issuing a SAS No. 112 report that includes at the very least significant deficiencies in the area of lack of segregation of duties and lack of expertise in financial accounting and reporting."[18]

SAS No. 112 also requires the auditor to follow up on reported deficiencies. Auditors must continue to report significant deficiencies and material weaknesses until the client chooses to remedy the problems in internal control. The mandate to follow up on prior years' deficiencies will lead to more audit work and potentially higher audit fees.

Many smaller governmental entities (i.e., local school boards, utility districts, etc.) often contract with their audit firm to draft the financial statements. This is a material weakness if there are no internal controls over the financial reporting process. Prior to SAS No. 112, auditors routinely prepared the financial statements for small units of government and public authorities. Budget constraints and the absence of qualified accounting personnel made it more cost effective and necessary for auditors to perform these tasks. With this auditing standard, auditors can still propose adjustments to the statements and assist in the assembling or drafting of the financial statements when proper internal controls exist. However, the independent auditor can't drive, complete, or oversee the financial reporting process without reporting a material weakness in internal controls.

Even though auditing standards may permit auditor involvement in the preparation of financial statements, auditors may choose not to draft a client's financial statements due to potential independence issues which could lead to a disclaimer or "no opinion" report. To avoid this situation, management must designate an existing employee or hire a new employee that is qualified, competent, and effective to oversee the work of the audit firm. This may not be possible due to lack of expertise on the part of existing employees and insufficient available funding for training current and hiring new personnel. In cases where the auditor cannot or will not prepare the financial statements, and where controls are weak or nonexistent, the client has no choice but to accept the auditor's finding of a material weakness. In these situations, the auditor must continue to report and the client must continue to accept the material weakness finding until it is remediated.

To eliminate the auditor's role in financial statement preparation, management could engage an outside contractor, including a second accounting firm, to prepare the financial statements. If the audit firm continues to assist with the preparation of the financial statements, then another option for management is to hire an outside entity to review the financial statements and consider the review as a part of management's internal control over financial reporting. In this situation auditors could assist with the financial statements and remain independent. These are potentially very costly options but may be appropriate in order to reduce the likelihood of a material weakness in internal control.

The Government Finance Officers Association (GFOA) publishes recommended practices in government accounting, auditing, and financial reporting. The GFOA does not recommend the outsourcing of the financial statement to a second accounting firm when internal controls over financial reporting are weak. Contracting this work to outsiders may not identify or address other potential factors that could be considered a significant deficiency or material weakness in internal control. As a result, the governmental entity could still have significant deficiencies and material weaknesses with financial statements that are prepared by an outside firm. The GFOA prefers a more comprehensive approach to internal control that involves the design and implementation of effective controls by the governmental unit.[19]

Preparing for Changes in Auditing Standards

The GAO's adoption of the risk assessment suite (SAS Nos. 104-111) of standards and the implementation of SAS No. 112 represent fundamental shifts in the audit process. It is important for government financial managers to understand these changes and anticipate the potential audit implications. Many state comptrollers, treasurers, and auditors publish guidelines and conduct continuing professional education courses on new developments in accounting, including risk-based auditing and internal control. For example: The State of Minnesota Office of the State Auditor has warned that "New Auditing Standards Will Impact the Conduct of Your Annual Audit" and specifically outlined their recommendations. The Government Finance Officers Association also released "Mitigating the Negative Effects of Statement on Auditing Standards No. 112", in an attempt to assist local governments in minimizing any potential negative consequences. Table 4 below provides a brief description of these recommendations in preparation of SAS No. 112.

TABLE 4

Recommendations Made for Implementing SAS No. 112

- Educate yourself to key components of strong internal controls and required disclosures
- Eliminate all audit adjustments
- Educate your governing body
- Inventory your system as to accounts, disclosures and processes used in your organization
- Prioritize: Don't try to fix everything at once. Improve greatest weaknesses first.
- Notify your board now of potential for more audit finding than in the past

Source: State of Minnesota Office of the State Auditor[20]

- Be prepared to show that the governmental agency has a sound financial reporting system in place
- Minimize likelihood of material audit adjustments
- Review the assistance in financial statement presentation provided by the independent auditors
- Do not engage services of a second accounting firm to assist in financial statement preparation only to avoid a significant weakness or material weakness

Source: Government Finance Officers Association[21]

Concluding Remarks

Finance officers should seek clarification from their auditors on how new audit standards will affect the nature, timing, extent, and cost of audit procedures and reports. Governmental entities should examine their internal controls over financial reporting and compliance with major federal programs in light of the requirement for auditors to report in writing any significant deficiencies and material weaknesses. Finally, financial managers and those charged with oversight of governmental units should focus on risk identification and risk management to improve performance and facilitate the audit process.

Endnotes

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