

UNDERSTANDING YOUR INDEPENDENT AUDIT

(Editor's Note: Several municipalities around the State have recently been in the news as they grapple with fiscal recordkeeping and reporting issues. Staff turnover, confusing records, and unexpected financial shortfalls have posed challenges for these municipalities, challenges that are highlighted by their independent auditor's report at the end of the fiscal year. Below, VLCT's Chief Financial Officer Michael Gilbar offers some guidance for selectboards on how to interpret and use your independent auditor's report at the end of the year.)

Here's a familiar scenario for selectboard members: your municipal accounting staff and treasurer spend the fiscal year crunching numbers and generating reports that you make a valiant effort to digest and understand. At year-end your independent auditor rolls in and generates an even more baffling set of numbers and a narrative that make you wonder what possessed you to run for the selectboard in the first place.

First, I should tell you up front that municipal finance is not just a matter of keeping and balancing the town's checkbook. Hundreds, if not thousands, of transactions go through the town books each year, including complex payroll and benefits payments. It takes someone with pretty solid accounting experience or training to successfully manage the numerous processes required to come up with a balanced set of books. Poor internal controls and careless bookkeeping practices can result in inaccurate reporting and create the perfect opportunity for fraud. Following generally accepted accounting practices set by the Government Accounting Standards Board (GASB) is a way to ensure that transactions are more accurately booked and reported, though fraud can still occur under the best circumstances if the perpetrator is determined and wily enough.

So what do the independent auditors you hire actually do? First, they take a look at the accounting processes and principles used by the town, along with its internal controls. These are the procedures you have in place to ensure that your records are accurate, comply with all legal requirements (statutory and otherwise), and are as fraud-proof as possible. Next, they do their field tests by taking transactions from your trial balance (the listing of all of your account balances including revenues, expenses, assets and liabilities) and tracking down the source documents to be sure that everything was processed properly and recorded correctly. They essentially start with your trial balance and work backwards through the process to the beginning of the transaction. If you have poor internal controls and do not follow generally accepted accounting principles (GAAP), they will choose many more transactions to test, assuming that there is an increased chance for error or fraud. New standards resulting from the Enron fiasco have introduced a degree of unpredictability into the auditing process, making testing more random and unpredictable in order to ensure that unscrupulous employees aren't able to "work the system" to avoid detection.

The result of all this testing is to determine if the financial statements are free of "material misstatement." In other words, the auditors will offer an opinion on whether or not the financial statements fairly represent the true financial condition of the town. This opinion is generally found in the first couple of pages of the independent auditor's report, before the financial statements. This section of the report will also indicate if the town is in or out of compliance with GAAP as defined by GASB. If you are not in compliance there is the chance that your financial statements could contain material errors. Selectboards should read the

audit carefully and should always have the independent auditor present his or her findings at a regular board meeting.

In addition to this report, a management letter is provided that will report any material weaknesses in the accounting system. These are things the auditor considers important enough to be addressed and corrected. Examples would be inadequate documentation of payments being processed or bank accounts not being reconciled. Other reportable conditions that are not deemed to be material are also listed in the management letter and may include items such as lack of an approval process for journal entries or inadequate documentation of accounting processes.

Besides the report indicating compliance with GASB and the management letter, your audit contains the management's discussion and analysis (MD&A), financial statements (two sets now with the advent of GASB 34), and notes to the financials.

- The MD&A, which is also new with GASB 34, is a narrative that summarizes the financials in plain English.
- The financial statements consist of the government-wide statements that show the "economic" resources of the town, including capital assets and long-term debt for government funds, and the fund statements, which are pretty much what you've seen in the past, with capital assets and long-term debt only in your enterprise funds. Of course, there are other differences in the statements, but the major difference is the effect of reporting capital and debt.
- After the financials you will find the notes and disclosures that provide the detail behind the numbers.

What should selectboards look for in all of these materials? First, read the pages at the beginning to determine the auditor's opinion. If you are out of compliance, you should develop a plan to come into compliance. Though the immediate consequences of being out of compliance are mainly political, you may find later on that if bond-rating agencies become less lenient, institutions that provide debt financing could require compliance. Also, federal and state agencies providing grant funding may tighten their guidelines and towns could lose grant monies. Finally, from an accountability standpoint, it is simply good practice to handle finances in a professional manner, following reasonable uniform standards.

Read the MD&A carefully to get an overview of the financial position and operations and take a look at both sets of financial statements. You will notice the net assets in the government funds in the government-wide statements and the fund balance of the government funds in the fund statements are different if you're complying with GASB 34. Your net assets for your government funds include capital assets, less related debt and delinquent taxes that were still outstanding sixty days after the close of the fiscal year of the audit. Your fund balance does not include these things. For budgeting purposes you should use your undesignated fund balance from the government funds in the fund statements. Look at this number to determine if you have a surplus or deficit.

You should also read the notes to the financials. They contain important information about your municipality's accounting practices as well as the detail behind the various accounts such as cash, investments, receivables, prepaid expenses, capital assets, payables, short and long-term debt, and fund balances. The numbers in any of your notes should tie back into your financial statements, so read each note and find the numbers in the financials.

Above all, don't be afraid to ask your independent auditor questions when you are presented with the audit report, or anytime thereafter. That's what the auditor gets paid for and there's not an accountant in the world that doesn't love talking about the intricacies of financial reporting!

It may take a while to understand the audit report, but you will eventually become adept at both analyzing the figures and presenting a clearer picture of your overall finances. This will, in turn, give you more reliable information to make better decisions and will help you avoid those nasty little public spats that make elected officials look like they don't know how to handle taxpayer funds.

- Michael Gilbar, VLCT Chief Financial Officer

(For more information on scheduling an on-site workshop on Understanding Municipal Finances, please contact the VLCT Municipal Assistance Center.)

VLCT News, June 2006